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TAX REFORM: EXAMINING THE TAXATION OF BUSINESS ENTITIES

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

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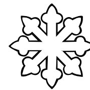

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TAX REFORM: EXAMINING THE TAXATION OF BUSINESS ENTITIES

WEDNESDAY, AUGUST 1, 2012

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:38 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Bingaman, Wyden, Menendez, Carper, Cardin, Hatch, Crapo, Cornyn, and Thune.

Also present: Democratic Staff: Lily Batchelder, Chief Tax Counsel; Holly Porter, Tax Counsel; and David Hughes, Senior Business and Accounting Advisor. Republican Staff: Chris Campbell, Staff Director; and Christopher Hanna, Senior Tax Policy Advisor.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Baseball great Babe Ruth once said, "Yesterday's home runs don't win today's games."

The same is true in our modern economy. Businesses have to be responsive to the changing landscape around them. Today, that landscape offers many different pathways to success. For example, that success could come through an IPO, private investment, or by forming a pass-through.

For some businesses, the ultimate success is the IPO. This is when, after months or years of hard work, a business debuts as a publicly traded company. Once believed to be the best route forward for growing a business, IPOs are becoming less and less common. In the 20-year period from 1980 to the year 2000, nearly 300 United States companies went public each year. In this past decade, the average fell to 90 companies per year.

Fewer businesses are filing their taxes as C corporations, which are taxed separately from their shareholders. That number has been falling at a fairly steady pace for the past 25 years, from a high of 2.6 million corporations in 1986 to 1.7 million in 2009. But even with fewer IPOs and C corporations, the total number of businesses has increased steadily over the past 20 years.

Why are more and more businesses avoiding stock markets, once seen as the pinnacle of business success? Today, a business can obtain the capital they need to grow through a variety of sources, including private equity, venture capital, and private placements. In

addition, many businesses may want to avoid the higher taxes that come with listing on an established stock exchange.

Today, 95 percent of all U.S. businesses are structured as so-called pass-through entities—95 percent—which are partnerships, limited liability firms, sole proprietorships, and S corporations.

Originally used primarily by small businesses, recent changes in the law have made it easier for medium and large businesses to be taxed as pass-throughs and still retain the benefits of limited liability. The pass-through structures give businesses unique tax incentives that might discourage companies from accessing stock markets. Pass-throughs do not pay corporate taxes. Their business income is taxed at individual income rates.

However, C corporations get taxed on income, and then, when that money is distributed in dividends to shareholders, it is taxed again. While a valuable tool for small businesses, we should examine if the use of pass-throughs has disrupted the playing field for larger non-public companies and their public competitors.

Ideally, our tax code should cause as few distortions in business as possible. Businesses should plan and organize based on growth and job creation, not on the code. One of my main goals of tax reform is to make the system more competitive, but also keep it fair.

Our hearing this morning will examine the difference between corporate and pass-through taxation and whether current rules strike the right balance in our diverse economy.

Today, we will explore various proposals to reform our tax system, ranging from the idea of creating one business-level tax through some method of integration, to proposals to treat large pass-throughs as corporations.

We will also discuss more tailored changes. That could mean simplifying the complex ways the tax code treats different pass-throughs or simplifying the audit process of large pass-through entities.

Many businesses have urged Congress to enact corporate tax reform, arguing that the United States is out of step with international rates and methods of taxing foreign income. It is important for us to compare how all forms of businesses are taxed internationally. We will discuss that today as well.

Recently, I outlined four goals that must be at the heart of any tax reform plan. These are the creation of jobs from broad-based growth, competitiveness in world markets, innovation, and opportunity.

Whatever changes we make to the corporate tax code must result in a more efficient system. We want businesses focusing their energy and their resources on growth and on jobs. I look forward to discussing these issues today.

So let us remember that, for entrepreneurs, the American dream is to create an idea, build a business, and then watch as the hard work and sacrifice turn to success. Let us remember Babe Ruth's words, and remember that "yesterday's home runs won't win today's games." And let us build a tax code that works for today and, I might add, for tomorrow.*

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*For more information, *see also,* "Selected Issues Relating to Choice of Business Entity," Joint Committee on Taxation staff report, July 27, 2012 (JCX–66–12), *https://www.jct.gov/publications.html?func=startdown&id=4478.*

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman. And I want to thank our witnesses for appearing here today. We appreciate the time that you are spending and the education that you are bringing to us. It is a very good thing.

There seems to be a lot of interest around this country, and really around the world, in corporate tax reform, which is understandable given that the top U.S. corporate tax rate of 35 percent is about 10 percentage points higher than the average top corporate tax rate of the OECD countries.

But corporate tax reform should really be viewed as part of business tax reform, which is the subject of our hearing today.

As is well-known to tax scholars and the business community, the earnings of a C corporation are taxed once at the corporate level and a second time at the shareholder level, if the earnings are distributed in the form of a dividend. As a result, the earnings of a corporation may be subject to two levels of taxation, a system generally referred to as the classical system of taxation.

For many years, the U.S. Treasury Department, the organized tax bar, and other interested parties have advanced a number of proposals to integrate the individual and corporate level of taxes. Now, it makes no sense today to have two levels of taxation of corporate earnings. In fact, I am not sure it ever made sense to have two levels of taxation, even in the early years of our income tax system.

Earlier this year, President Obama released his framework for business tax reform. One of the really bad ideas in there was to double-tax certain pass-through entities. Like all bad ideas, this one should be rejected.

All business income, whether earned by a C corporation, a large pass-through entity, or a small business, should be subject to a single level of tax, either at the entity level or at the owner level.

A big challenge in moving to a tax system in which all business income is subject to a single level of tax, which we should do, is that such a system may raise less revenue than the current system.

In 2003, Congress enacted preferential tax treatment for dividend income, leading to partial integration of the individual and corporate level taxes. Next year, an additional tax on capital gains and dividends is scheduled to go into effect.

As part of Obamacare, the Democrats enacted a 3.8-percent tax on the net investment income of single taxpayers earning more than $200,000 and married couples earning more than $250,000. These amounts are not indexed for inflation at all.

With the scheduled expiration of the 2001 and 2003 tax cuts at the end of this year, capital gains will be subject to a 23.8-percent tax beginning in 2013, a 59-percent increase from current law. Dividend income will be subject to a 43.4-percent tax in 2013, a 189-percent increase from current law. The result would be a return to

the classical system of taxing the earnings of the corporation, with all the distortions that accompany such a system.

With the top corporate tax rate of 35 percent, coupled with an average 4-percent State corporate tax rate, the U.S. has the highest corporate tax rate in the developed world. The top corporate tax rate should be reduced by at least 10 percentage points, to a maximum of 25 percent, which would bring the U.S. in close alignment with other OECD countries.

The top individual rate should also be substantially reduced. And having both the corporate and individual tax rates at approximately the same percentage, or percentages, coupled with corporate integration, will achieve a large measure of parity in the taxation of business income, whether earned by a corporation, partnership, limited liability company, or sole proprietorship.

In my opinion, we have a great panel of witnesses, and I look forward to hearing what all of you have to say, and we really appreciate you, again, for being here.

Thanks, Mr. Chairman.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Thank you very much, Senator. I appreciate all your work on this committee.

Let me introduce the panel. The first witness is Mr. Harrison LeFrak. Mr. LeFrak is the vice chairman of the LeFrak Organization. We appreciate you being here, Mr. LeFrak. Next is Mr. Dana Trier. Mr. Trier is an adjunct professor of taxation at both the University of Miami and Columbia Law Schools. Our third witness is Mr. Alvin Warren. Mr. Warren is the Ropes and Gray professor of law at Harvard Law School. The fourth witness is Mr. Fred de Hosson. Mr. de Hosson is the managing partner of Baker and McKenzie's Amsterdam office.

Thank you all very much for coming. This is a very important hearing. This subject today goes so much to the heart of how we resolve all these conflicts; that is, reduce the top corporate rate, get rid of a lot of corporate tax expenditures, how it affects passthroughs on the individual side, and how we approach taxing business income roughly as equally as possible, irrespective of that business's organization, and recognizing, too, we want to be more competitive as a country.

I think is a very important hearing, and we deeply appreciate your time devoted to help us and help resolve this problem.

So why don't you begin, Mr. LeFrak?

As you know, we urge you to speak about 5 minutes, and summarize. Your statements will be automatically put in the record. But tell us what you think. Time is short, life is short. Let us know.

Thanks.

STATEMENT OF HARRISON T. LeFRAK, VICE CHAIRMAN, THE LeFRAK ORGANIZATION, NEW YORK, NY

Mr. LEFRAK. Good morning, Chairman Baucus, Ranking Member Hatch, and members of the committee. My name is Harrison LeFrak. I am vice chairman of the LeFrak Organization.

I appreciate the opportunity to discuss why maintaining the current taxation of pass-through entities is essential for the continued health and growth of real estate, oil and gas, entrepreneurship, and investment in the United States.

The LeFrak Organization is comprised of three business platforms: real estate development, energy exploration, and investments—ground floor investments in the companies of tomorrow, as well as securities management and ownership.

The LeFrak Organization was founded in 1901 and owns an extensive portfolio of real property concentrated in the New York, Los Angeles, South Florida, and London metropolitan areas. The LeFrak Organization and its affiliated companies have developed and built a majority of their own portfolio. Since the 1980s, affiliates of LeFrak Organization have developed Newport, the largest new waterfront community in the United States. Newport transformed an abandoned rail yard into what is now more than 1 percent of the State of New Jersey's gross State product. We have recently begun new projects in Miami Beach and North Miami, FL.

Affiliates of our company have originated and drilled a significant number of onshore oil and gas wells in the continental United States. We have a very exciting shale oil project in Nebraska, which, if successful, will be transformative to that State. As a domestic explorer and producer, we are doing our small part for America's energy independence.

Affiliates of our company have provided and continue to provide strategic capital to entrepreneurs and early-stage businesses in technology, financial services, and health care. We have invested in numerous start-up companies that have created hundreds of jobs. Locations of these companies include California, South Florida, Michigan, Texas, and New York. In addition, the LeFrak Organization has been an investor in fixed income and equity securities, currencies, and commodities.

Partnerships allow our business to establish discrete entities for each enterprise. Each project, building, or oil field is in its own partnership. The ownership of each project or business reflects the objectives, risk tolerance, and liquidity needs of various family members and investors.

In addition, each partnership provides a discrete way to measure the success or failure of outcomes and to limit risk on a project-by-project basis. Furthermore, our lenders demand separate partnerships for each activity that we undertake that they are financing. Lenders want a guarantee that the assets they are financing are protected and not subject to third-party claims arising from unrelated business activities. Lenders demand that the assets are compartmentalized, especially in the event of bankruptcy.

We do not use corporations as investment vehicles to conduct our business, because the cumulative rate of taxation on our enterprises would be confiscatory. The following example illustrates why the use of corporations would be inefficient. In 2012, our business is conducted in partnership form, and our combined effective tax rate is 51.188 percent. That means more than half of our income is devoted to taxes.

In 2012, if our business were conducted in corporate form and all profits were paid as a dividend to enable capital to be reinvested,

the tax rate would be 64.53 percent, and this does not take into account the AMT or PEP/Pease.

In 2013, under present law, if our business were conducted in corporate form, our combined effective tax rate would be 78.45 percent. We are a family enterprise and invest more than 95 percent of our business income back into our business activities, and this tax proposal would be particularly onerous. We also rely on our own capital to fund our business activities and do not receive $1 of carried interest income.

If this proposal becomes law, my family will stop drilling, stop building, and stop taking risks. As you can see, we would have paid 64.53 percent of our business income as tax. That would have meant that we would have had to work 7½ months a year to pay our taxes. In 2013, if we were forced into corporate taxation, we would have to work 9½ months to pay our taxes. Add that on top of a 55-percent estate tax, and there is little incentive for entrepreneurs like ourselves to continue to work.

The LeFrak Organization employs, directly and indirectly, more than 3,000 people. Many of them would lose their jobs. We are a blue-collar jobs machine everywhere we invest. The only jobs that this proposal would create are for tax lawyers and accountants, as this proposal would add incredible complexity and enormous effort to our annual tax compliance process.

A lot of complexity would need to be addressed in transition. Are current entities grandfathered? How will partnerships address changes in economics that were not part of the business when they were formed? What would happen if you had UPREITs, DownREITs, different complexity in different corporate structures?

Since Ronald Reagan, the policy of this Congress has been to eliminate the double taxation of business income. This proposal represents a major step backwards from that policy. It would create tremendous incentives for people to invest offshore, because Canada, the United Kingdom, and Australia, all three countries, do not double-tax partnership income in the way proposed. This would be highly anticompetitive for the United States and, in my opinion, would be very, very negative in terms of creating employment and economic activity.

Thank you. This concludes my testimony. I am very happy to answer any questions you may have.

[The prepared statement of Mr. LeFrak appears in the appendix.]

The CHAIRMAN. Thank you, Mr. LeFrak.

Next, Mr. Trier?

STATEMENT OF DANA L. TRIER, ADJUNCT PROFESSOR IN TAXATION, UNIVERSITY OF MIAMI SCHOOL OF LAW, AND LECTURER IN LAW, COLUMBIA UNIVERSITY LAW SCHOOL, NEW YORK, NY

Mr. TRIER. Thank you very much, Mr. Chairman, Senator Hatch, and members. Let me summarize my testimony as briefly as possible, and I assume we will have a robust discussion of specific topics.

First of all, I come at this subject pretty closely to the overall philosophy articulated by Senator Hatch. One level of tax, as little

distortion as possible, the importance of being competitive; but on the other hand, of course, we have to raise revenue.

The difficulty is getting from here to there consistent with our revenue needs in this very complex situation we live in now. In my testimony, I am not going to concentrate on the various integration possibilities. Professor Warren is going to concentrate on that. But I thought I would add perspective on what I consider three big issues and then a couple of smaller issues.

The first big issue is really, in many ways, raised by the opening statements. I think that the action-forcing event, the gating issue, that may affect everything is where we come to in our initial rate of tax for corporate income. And I am very, very much of the view that we ought to at least be considering seriously, and working at, as you have been working, getting that rate down from 35 percent to a lower rate because of competitiveness situations.

Unlike Ranking Member Hatch, however, in my thinking about this, I have to think about whether we end up, through our various base-broadening work, at a situation where we have a maximum rate at the individual level that is somewhat different than at the corporate rate after we have accomplished our reform.

So a major part of my written testimony is dealing with that prospect and what are the constraints on that.

To make the long and short of it, I believe that if the disparity became too great, we would go back to a world that I was very successful in and very familiar with before the Reagan revolution, before the 1980s and the 1990s, in which a type of tax planning would be involved, involving the accumulated earnings tax and all sorts of complexities. So in my mind, it is a step backward rather than a step forward.

So a gating issue for me is whether our base-broadening is used to keep the maximum rates reasonably close, not necessarily identical, but within 5, 6, 7 percent. So that is my first core question. There has been a lot written about that, but I myself am skeptical that the system is rational if the maximum rates go back to the larger number.

The second thing is something that you people tend not to concentrate on, but I practiced law for 30 years, the last 20 years around Wall Street, and I live in a world where we are not simply talking about subchapter S corporations, partnerships, corporations, et cetera. They did not come to Dana Trier to do that. They came to do structures that involved, in the same structure, a partnership, a subchapter C corporation; many times, subchapter S corporations at the top; many times, foreign taxpayers, et cetera. And many of them were pass-throughs in that setting.

So the second big question I have is whether we actually understand what is happening in that world, a world that I was intimately involved in, but did not necessarily understand the full effect of. And in that particular regard, I am convinced that, as the committee goes forward in its work, and its staffs go forward in their work, in particular, we have to pay attention to the growing use of blockers and similar entities, those that cut off income.

I am not suggesting that there is something terrible going on so much as suggesting that we do not necessarily understand exactly what is going on, and we need to wrap our arms around it.

The third point I would suggest, which I do not deal with in tremendous detail here but I think is ultimately a big question, is whether we are fully capturing the U.S. business income that we should be. And I start with prejudices relating back to my years in two Republican administrations that are similar to those articulated by Senator Hatch today, in that we want one tax, et cetera. But a very important aspect of that is to get one tax fully, not for it to be escaping into the netherworld of foreign taxpayers or perhaps too much escaping to the tax-exempt sector.

So a major emphasis of my own testimony and thought on this question is that, while we are bringing the corporate rates down, while we are rationalizing and, in many ways, keeping the treatment of pass-throughs, are we assuring that basic level of tax? And I might say, harkening back to my period in Treasury, late 1980s, early 1990s, we had exactly the same question.

I have been thinking about this question for 30-some years. Nothing really changes. Much of it is in the literature that Professor Warren talks about: what is that interface?

So the only other two topics I discuss I do not think are big ones; that is, the treatment of the services companies, the service organizations, in which we completely have to capture one tax, we have to capture this wage income, but I do not think we need to talk about treating big service companies as corporations subject to the 2-level tax.

The other issue is something that I have worked with your now former staff members and Chairman Baucus on a few years ago, which is the treatment of the publicly traded partnership. I do not think that is where the real action is in this. I have some points I make in my testimony, but I am actually somewhat more satisfied with the current situation than one might expect.

So with that, I thank you, and I look forward to talking about this later.

[The prepared statement of Mr. Trier appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Trier, very, very much. That is fascinating, provocative even.

Mr. Warren?

STATEMENT OF ALVIN C. WARREN, ROPES AND GRAY PROFESSOR OF LAW, HARVARD LAW SCHOOL, CAMBRIDGE, MA

Mr. WARREN. Chairman Baucus, Ranking Member Hatch, and members of the committee, thank you for inviting me to testify today on this challenging and important subject. I would like to emphasize three points.

First, the long-standing U.S. taxation of corporate entities and their investors is in need of reform to reduce economic distortions. Often called a double-tax system, our tax law actually sometimes results in corporate income being taxed twice, sometimes once, and sometimes not at all.

These distortions depend crucially on the relationships among four different tax rates: the tax rate on corporate income; the tax rate on individual business income; the tax rate on corporate distributions, such as dividends; and the tax rate on capital gains on the sale of corporate shares. Depending on the relationships, business decisions about whether to incorporate, whether to finance by

debt or equity, and whether to retain or distribute earnings can be distorted in different ways.

My second point is that these long-standing distortions in the taxation of business entities have been exacerbated in recent years by two important developments. The first is the dramatic rise in the use of pass-through entities, including limited liability companies or LLCs, to conduct business in the United States. Pass-through business income, which represented less than a quarter of all business income in 1980, is now more than 70 percent of such income.

The other recent development that is important for the taxation of business entities has been the growth of private equity. Historically, in the United States, business owners chose to incorporate in order to receive certain non-tax advantages, including limited liability and access to public capital markets.

The tax consequences of such incorporation usually included the entity-level Federal income tax. But with the rise of LLCs, incorporation is no longer necessary to achieve limited liability. With the rise of private equity, incorporation is no longer necessary to have access to large pools of capital. Incorporation is not even necessary for some publicly traded partnerships to tap the public capital markets. These changes mean that the boundary between taxable corporations and pass-through entities should be reconsidered.

My third and final point is that the foregoing challenges are made even more difficult for the committee and the Congress by the continuing globalization of the economy. American companies and investors receive a growing portion of their income from abroad. Foreign companies and individuals continue to invest in the U.S. economy.

As a result, proposed changes in the taxation of business entities in the U.S. have to be evaluated in the context of a variety of investment patterns. For analytical purposes, consider a world in which there are just two categories of income: U.S. and foreign; just four categories of entities: U.S. corporations, U.S. pass-throughs, foreign corporations, and foreign pass-throughs; and three categories of equity investors: U.S. taxable investors, U.S. exempt investors, and foreign investors.

In that somewhat simplified world, any change in the taxation of entities and their investors will have consequences for more than 20 different cases that have to be taken into account in evaluating any proposed legislation.

Given these complexities, how should the committee approach the issue of entity taxation? My own view is that economic production, distributional fairness, and administrative simplicity would all be best served by moving further toward the goal of taxing all business income once, but only once. To the extent possible, the same tax rate should apply, no matter how the business is organized or financed.

The level of that rate is, of course, a separate question from how to structure the taxation of entities to advance the goal of neutrality.

Thank you, again, Mr. Chairman, for inviting me to testify today. I look forward to responding to any questions the committee might have.

[The prepared statement of Mr. Warren appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Warren.

Mr. de Hosson?

STATEMENT OF FRED C. de HOSSON, PARTNER, BAKER AND McKENZIE, AMSTERDAM, THE NETHERLANDS

Mr. DE HOSSON. Thank you. Good morning, Mr. Chairman, Ranking Member Hatch, members of the committee.

I was asked this morning to address the question of, why are Western European countries—if we are talking about Western European countries, we are talking about the European Union—why are member states of the European Union making so much less use of the so-called pass-through entities? Because that is for sure: they make a lot less use of them.

Of course, they are used by very small businesses, sole proprietors, and what have you. Sometimes professionals are, more or less, forced to use partnerships. In my profession, for instance, bar rules may require that.

Every now and then, there are tax incentives like depreciation facilitation, which would be useful if you could take them through the pass-through entity against your other source income. Besides that, what you see in Europe is that almost all businesses are incorporated, all medium-sized businesses are incorporated, and let me explain why that is.

First of all, there is the legal certainty that incorporation offers in many countries, including my country, the Netherlands, where there is a lack of legal personality for the partnership. A partnership, as such, cannot have legal title to assets. Liabilities are a big issue.

So there are ways around that, but it is, quite frankly, very clumsy if you want to run a medium-sized, let alone a larger business.

The second reason why that is is, simply, it is cheaper to have a corporation. Tax-wise, it is cheaper. Since 1992, when the single market came along, corporate tax rates have come down dramatically. Personal income tax rates, on the other hand, less so, and some of them went up. The recent trend, as we see in France, is to increase the personal income tax rates and leave alone the corporate tax rates. I will come back to that later.

You may say that will result, in the use of a corporation, in double taxation. At the end of the day, that is not really an issue in Europe. We used to have, as you may know, imputation systems, but the European court ruled out almost all of these imputation systems because they tend to be discriminatory. Either they discriminate against foreign source income or they discriminate against foreign shareholders, EU shareholders, of course.

So they are basically gone in Europe, and they have been replaced by what you call the classical system. But even if we have those classical systems in place, we still have much lower corporate income tax rates, certainly much lower than the U.S. tax rates.

We still have the deferral of taxation with personal income tax until the moment of distribution. And we have, in most countries now, special income tax rates for dividends received by the share-

holders. In other words, tax-wise, it is much cheaper to have a corporation than, let us say, a partnership.

The third reason I would like to point out to you is the very different environment wherein European businesses are active. It has to do with the big difference between our two economies. The U.S. national market is huge. It is $15 trillion GDP in 2012.

So U.S. businesses can grow for a long time by expanding in that market. If you have a business in Houston and you want to be closer to your customers in Buffalo, it is very easy to set up a business, a plant, in Buffalo.

The EU market, as such, is even bigger. It was $17 trillion in 1992. And it developed from a customs union, original customs union, a true single market after 1992. That means that besides the customs duties, all sorts of regulatory obstacles have been removed. We call that harmonization, and that is basically done through what we call directives, legislative measures coming from the European Union, approved by the member states.

But there are still sizeable differences among the member states, and those differences are in the legal systems and in the tax systems of the member states. They are not harmonized or are not fully harmonized.

So a business growing—if I have a business in Amsterdam and I want to be closer to my customers in Frankfurt, I have to operate in a totally different legal and taxing environment, and that means, basically, that I have to use a corporation.

What we have seen in the last few years, last 10 years, 15 years, is that the disadvantages of partnerships or pass-through entities simply increased. Legal issues at the national level have been compounded by the impact at other member states' levels. Tax characterization of a pass-through entity in other member states can be a serious headache. Tax treaties do not always solve those problems.

On the other side, if you take a look at the corporate taxation in Europe, there is a certain area, a certain trend to harmonize, and that goes through various measures, so to say. It goes through the corporate directives. We have the parent-subsidiary directives, which provide for a zero rate on intergroup dividend payments. We have the merger directive, which allows corporations to reorganize within the common market.

We also have what we call cold harmonization, which means that, within that common market, a lot of tax competition is going on to attract investments from other member states. Capital is mobile. Persons are not mobile in the European Union.

So there is a lot that you see reflected in the corporate tax rates. There is a lot of competition to attract corporate investments, which results in reduced corporate tax rates. Member states are really competing here. But persons, much less than in the United States, are not mobile. They stick to their region, to their country, and even to their town. So personal income tax rates are much easier for governments to raise than corporate tax rates.

You see that even—I mentioned it in my testimony—you see even that the tax competition has resulted in the introduction across the Union of territorial systems. Even the U.K. has now introduced a territorial system of taxation.

So, in a relative sense, there is almost no improvement for cross-border investment through pass-through entities, and there have been dramatic improvements for cross-border investments through corporations.

To come to a conclusion, Mr. Chairman, the use of a corporation in Europe is cheaper, it is more certain, that is, in domestically and especially international contexts, both in legal terms and in tax terms.

That concludes my testimony.

[The prepared statement of Mr. de Hosson appears in the appendix.]

The CHAIRMAN. Thank you, sir, very much.

Mr. Trier, you indicated some concern about blockers——

Mr. TRIER. Yes.

The CHAIRMAN [continuing]. And potentially leakage with respect to tax-exempt entities and perhaps foreign income. Could you just explain a little more precisely how business income allocable to a tax-exempt or a foreign investor is able to set up a blocker or stopper and escape U.S. tax today? How would you address that?

Mr. TRIER. Let me go to basics and, in a sense, go back to something that Professor Warren said. Today, a tax-exempt or a foreign person could not directly invest in an ongoing business that is conducted as a pass-through.

Why? Because it would be viewed as engaged in trade or business. And, as we all know from some other controversies, if that underlying entity had that business model, you would have the unrelated debt financed income rules.

So, unless the entity that they are ultimately investing in is a corporation, a U.S. corporation—and one thing that I would disagree, on the margin, with Professor Warren on is that there are quite a few emerging enterprise entities that are still in C corporations; a very large number are in pass-through LLCs, but many are still in corporations.

So, if they are going to invest in something that is a pass-through, they are going to set up a blocker corporation somewhere in the chain to deal with that setting. And that means that the blocker, hopefully, is subject to full U.S. tax. That is kind of the deal, if you will, between the tax-exempt and the non-tax-exempt sector, that all business income is subject to the income at the corporate level, and then the dividends or interest that are paid to the tax-exempt are tax-free.

What I am worried about is not that the sky is falling, et cetera. It is whether we have fully gotten that deal correct. And there are big issues, and there are small issues.

The big issue has been around forever and is one which I spent a lot of time on during my Treasury days. Remember those were the LBO days, et cetera. One big issue is whether, if the tax-exempt gets its return from the blocker as debt, is there too big an interest deduction at the blocker level, in effect pulling out income from the corporate sector and into the tax-exempt sector?

Professor Halperin, one of Professor Warren's colleagues, many years ago persuaded me that that was not a big issue. Guess what? I am still thinking about that particular issue.

So that is one core issue. I refer to that in my second or third point. I think, more broadly, you can actually see this with people from my milieu. Willard Taylor, who was a Sullivan and Cromwell partner while I was a Davis, Polk partner, has written an article on blockers.

We have so many different entities of that kind that I am not—I probably have as broad experience as anybody, and Willard Taylor also has a broad experience, and we are not sure that things are working out correctly.

So, even if I cannot spot the issue now, I think it has to be examined more precisely.

So, I do not know if that is responsive to your——

The CHAIRMAN. Well, it is. But it also raises another question. A great number of entities—and one of the goals here is simplicity, so we are spending more time making stuff, not making huge tax structures here. And, if the goal is to tax business income once, what does that tend you toward?

Mr. TRIER. Well, it is actually a very——

The CHAIRMAN. What changes do we consider here?

Mr. TRIER. Let me respond to that point in two different ways.

One point is that I have largely lived in a completely different world than you guys. I have lived in a world that has all these entities. And to some extent, what I am saying is, you cannot proceed with your work without understanding my world.

I think it partly, also, goes to Professor Warren's point and, really, the European experience. To some extent, the reason that world is so complex is that we planners are mixing and matching so as to only have one level of business income and then accommodate all the different parties, whether they be the tax-exempt parties, or the foreign parties that are investing through tax-exempts, or whether they be other people.

If we had a world that, through corporate integration, through other means, simply itself operated to get that one level of tax and then got the interface with the tax-exempts and foreign sectors correct, then we would not necessarily have this huge proliferation of entities.

But to be honest with you, I think the world that I come from is only going to get more complex. I am really more interested that we understand what is happening.

The CHAIRMAN. Does that bother you that the world is going to get even more complex? I mean, certainly the world is getting more complex, but does it bother you if taxation gets even more complex?

Mr. TRIER. I think that for a——

The CHAIRMAN. Why not do something more simple and straightforward? People want simplicity.

Mr. TRIER. Well, we are talking about Mr. LeFrak's father, who likes to keep the business—I am more in the world of simplicity. But listen, we live in an extraordinarily complex world, and it is fun, it is dynamic, it is great for a crazy guy like me, but I do not know that there is a lot of choice about that.

Of course, everybody understands that part of the reason it is so complex is because this is an extraordinarily international world. And you go up to a humble law firm like Davis, Polk, a third of the people who work there are foreign. We are doing work on—they

are doing work on this; it is not me anymore—they are doing work in many different foreign countries. There are going to be many different entities involved.

We have this basic problem that is going on now, which is, given the choice, many business entities are going to migrate someplace else, potentially, and I am afraid we are going to have to deal with that world.

But rationalizing our own system, I think, would tend to make it somewhat less complex. And then, of course, we have to deal with a different borderline, the borderline I mentioned in my testimony. I come from the industrial Midwest. My father had a subchapter S corporation, and my grandfather had a C corporation, and we do have to continue to make it possible for them.

It turns out, when you look at the Treasury Department analysis, it turned out, I now realize, they thought they were small businesses, but they were actually large businesses. But we have to make their world relatively——

The CHAIRMAN. Thank you very much.

Senator Hatch?

Senator HATCH. Thank you all. I appreciate you all being here.

This question is for the entire panel. As I noted in my opening statement, earlier this year, President Obama released his skeleton framework for business tax reform. One of the, what I consider to be bad ideas, was to double-tax certain flow-through entities. What do you think of President Obama's proposal to double-tax certain flow-through entities?

Maybe we should start with you, Mr. LeFrak, and move across the table.

Mr. LEFRAK. Senator Hatch, I think that it is actually one of the most terrible ideas that I have ever encountered. And, if we want to have a jobs funeral in the United States, that idea could be one of the opening hymns in a funeral for jobs in America.

Both from an economic point of view and from a tax complexity point of view, it is a terrible idea. Between States and Federal rates of income, it would put people who work in partnerships in a position of working for the government more than 9 months a year.

That is a very, very dramatic incentive-destroying set of facts. That is going to reduce employment, reduce capital at-risk, reduce entrepreneurship, and reduce a tremendous amount of the American spirit.

We do have a witness here who talked a lot about Europe. That is a very, very easy and fast way to make America's economy as weak and as regulated and as feeble as Europe's has been for the last 2 decades.

From a tax complexity point of view, just to think about how that idea might work, would current entities be grandfathered? If not, what would happen if there were new economics from these taxes that were different from when the investors came together?

Would the determination be based on income, revenue, size of assets? Would it apply on an annual basis, where you could be in it one year and not in it the next? How would it apply when a partnership is owned by another entity such as a REIT? What will happen if States do not follow the Internal Revenue Code and you have

a partnership for States' purposes and a corporation for Federal tax purposes?

In addition, my friends at the left here talked about pension funds and State pension funds and whether they should be paying their fair share of tax or not. If we had partnership-level business taxation in the United States, every one of the pension funds and State pension funds, charitable and tax-exempt entities, which currently invests in American partnerships, would stop investing in American partnerships. They would start investing in overseas partnerships and London partnerships.

So this would be a way to take the whole United States investment management industry and send it out of the United States to another country where partnership taxation does not carry with it a separate level of tax.

Countries like Australia, Canada, and the United Kingdom are all jurisdictions which do not have partnership-level business taxation, and there are very, very appropriate entities for well-founded, thoughtful fiduciaries to invest their money in in those jurisdictions.

These are not Cayman Islands jurisdictions. These are not third world jurisdictions. This is the United Kingdom, Australia, and Canada. And, if we want to have our whole investment management industry from the United States exported to those jurisdictions and those countries, having a separate layer of taxation on partnership income would be a fast and easy way to make sure that that happened.

Senator HATCH. Mr. Trier, I am running out of time.

Mr. TRIER. I would just say two quick things. First is that, to tell you the honest truth, I had trouble fully understanding the series of proposals that were made. It was a relatively sketchy document.

Number two is that conceptually, at a high level, I am not averse to there being sort of a single type of entity for business enterprises of all kinds. What I am very averse to is using that approach to end up or to move in a direction where there is more than one basic layer of tax.

You could imagine many design approaches to the one layer, but to the extent that you are talking about adding to that incremental one layer, I think it is a movement in the wrong direction rather than a movement in a positive direction.

Mr. WARREN. Just to be very brief, Senator Hatch, I take it the motivation for the proposal is that competing parties in a particular industry, such as the financial services industry, should be taxed similarly so that particular organizational forms do not have advantages over other organizational forms in the same industry.

Again, that sounds to me like, in the abstract, a perfectly acceptable proposition. This particular proposal, it seems to me, cannot be separated from what the rates are and from what the single entity taxation method is, as Mr. Trier just said.

So that if, in fact, the proposal is to reduce corporate tax rates and impose double taxation that would actually reduce taxes on particular sorts of pass-throughs, that is a very different sort of consequence than simply adding on additional taxes to certain pass-throughs.

So for me, analysis of the proposal would depend on exactly what the structure is going to be and what the rates are going to be.

Senator HATCH. Mr. de Hosson?

Mr. DE HOSSON. A proposal like that is not on the table anywhere in Europe, as far as I know. In Europe, the focus is much more on the corporations, the difference between corporation and partnership taxation, in general, and on how to find a rough balance, as it is called, and that is, more or less, achieved in many cases.

There is still, in a general sense, corporate tax. Business incorporated is taxed less than a pass-through entity, as I said, because of the high personal income tax rates in Europe. But still, what the governments seek is an overall balance, that is, the combination of personal income tax and corporate tax is more or less the same as in the case of direct taxation when you operate through a partnership.

As I said, that is not achieved in practice because, due to the tax competition and a lack of mobility of persons, there is a big difference between corporate income tax rates and personal income tax rates.

Senator HATCH. Well, thank you. I appreciate all four of you testifying. I am particularly happy to have Mr. LeFrak here. I am somewhat familiar with the businesses that the LeFrak family is in. And I have to say, this has been one of the most interesting panels we have had, and I just want to compliment all of you.

Thank you, Mr. Chairman, for your work on this.

The CHAIRMAN. Thank you, Senator.

Senator Crapo?

Senator CRAPO. Thank you, Mr. Chairman. I would just like to ask a quick question of the entire panel.

There has been a lot of discussion here today about seeking to have a single tax level for all business income. Do you all agree that that should be an objective of our efforts to reform the tax code? Is there anybody who disagrees with that objective?

Mr. WARREN. Maybe I could make one comment about it.

Senator CRAPO. Yes.

Mr. WARREN. I agree with the objective, but the pathway that is opened once we agree on that is really, what is that single level of tax going to be? And the real choice, the fundamental choice, that the committee has to think about is, are we going to try to tax investors on the income that they earn through companies at the same rate as on other income—that is, one single tax, that is a graduated tax—or are we going to have a separate tax on entities that may be unrelated to what the individual taxes are?

So I think buried in the consensus on a single level of tax, you may find some disagreement about what that means. Are we going to have a unique level of tax for all corporate income or is that going to be somehow related to what the individual investor's income is?

Senator CRAPO. And what would your thoughts on that be? How should that be structured?

Mr. WARREN. My own thoughts on it are related to what I think would be most distributionally fair and what I think would be the simplest in the end, which is to reduce distortions of the tax system

so that people will not use the tax system to try to organize their affairs differently than they otherwise would.

So I would start with the view that, however you earn your investment income, whether it is through a pass-through, through a sole proprietorship, or through a company, in the end, the same tax rate should apply. If we do not do that, people are going to have all sorts of pressure to play all sorts of games, to hire Dana Trier——

Mr. TRIER. I will come out of retirement.

Mr. WARREN [continuing]. To do all sorts of things for them.

Senator CRAPO. It should be taxed only once?

Mr. WARREN. Absolutely.

Senator CRAPO. What are you saying then—and I invite others on the panel to jump in here. What about the distinction between capital gains income versus ordinary income? Should those kinds of distinctions be maintained?

Mr. LEFRAK. I think you need to maintain that distinction, Senator, because we have this thing in this country called inflation, and, if we had $1 in the late 1960s when the country still had its currency pegged to gold, the asset was worth, in dollars' terms, what it was constantly worth in dollars' terms.

Since we have had this constant inflation of, not only the U.S. dollar, but fiat money throughout the world, the asset might not have had any change in its character, in its value whatsoever. It is the fact that the currency has had a big change in its value.

So what is pernicious about capital gains taxation is that one may not have had any accession to wealth whatsoever, which is what the income tax, in theory, is supposed to capture. But one may have a difference in the value of U.S. dollars of one's asset, not because the asset has changed in value, but because the U.S. dollar, the measuring scale, has changed in its value.

And one of the most important reasons to have a lower capital gains rate is because it is not indexed for inflation. So, if an asset was purchased in 1970 in 1970 dollars, sold in year 2012 in year-2012 dollars, it may not have appreciated in any way whatsoever. It may be that it is just worth more dollars because the value of the dollar has gone down over that 40-year period.

So one very important reason why the capital gains rate must be lower than the ordinary income rate is that it must be lower unless you are going to index for inflation the tax basis of assets. And without that indexation for inflation of the tax basis of assets, a lower rate is quite essential, because otherwise you are just taxing people for doing a transaction. You are not taxing their accession to wealth.

Senator CRAPO. Does anybody else want to weigh in on that? Yes?

Mr. WARREN. Just two comments. First of all, we have capital gains assets, some of which are shares of corporate stock.

Part of the reason, historically, for the concession in the rates on capital gains or shares of corporate stock is the double-tax system. So, if you moved away from the double-tax system, then you might want to rethink that particular result.

Secondly, if inflation—inflation is, obviously, a problem. If inflation is the rationale for the benefit of a lower rate for capital gains,

then you might want to rethink what the requirements are to get the lower rate.

If inflation is really the problem, probably you do not need to have a lower rate after investment of 6 months or a year. Maybe the benefit should depend on how long you have held the asset, which we have had in the past in our system.

So, whatever the rationale is for preferential treatment for capital gains, you should think about how that matches up with the actual requirements to get the lower rate today.

Senator CRAPO. Thank you.

Mr. Trier?

Mr. TRIER. I do not know if you have much time. And let me sort of add to his point. I was going to make the point that if we were not perfect in our integration system, the capital gains rate is having the effect of mitigating the second level of tax and, therefore, decreasing distortions.

If you look at a rough-justice guy like myself, one of the places I start is, I actually like our current rates. In an imperfect world, I like having the 15, and I can live with 20—probably you could not live with 20—percent rate on the dividends and a similar rate on the corporation as sort of a rough, modified integration.

The other point I would make is that, as I have come to think about it, this is a long story, because I have thought about the capital gains quite a bit. I emphasize, in my own thinking, a third concept, and that is the concept of lock-in. To me, one of the basic reasons for that capital gains preference, wherever we set it—I might set it at a higher level of rate than you would—but I know that moving from one asset to another in an efficient way is deterred if there is a full 40-percent tax on the appreciation. And, therefore, at some level, I still believe there is a reason for a capital gains preference to ease that movement from one business asset to another.

Senator CRAPO. Thank you. My time has expired, but I appreciate those answers. They were very helpful.

The CHAIRMAN. Thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Chairman, I am very glad you are holding this hearing. I think, as you and I have talked about, the question of taxation on the business side is absolutely crucial to doing tax reform right.

I am looking forward to working with you and Senator Hatch.

Here is my sense of where we are, for the four of you, and I am going to ask one question, and just go down the row.

There was a recent study by the accounting firm Ernst and Young, and they found that, a few years ago, pass-throughs, which of course are companies where the owners, investors, and partners pay individual income taxes on the business income—which make up 95 percent of American businesses and employ 54 percent of U.S. workers. And essentially, in this analysis, Ernst and Young found that reforming the code for corporations alone, for just corporations—and, as you know, there are some in Washington who are advocating that—would, in effect, raise income taxes for millions of these small pass-through businesses, whether they are or-

ganized as sole proprietorships, partnerships, or something else for tax purposes.

So the question that I would like to ask, and I am asking it because I think, if you look back at 1986, the resolution of this business issue was absolutely key to job creation. And the Bureau of Labor Statistics, in the 2 years after the 1986 bill, said the country created 6.3 million new jobs.

Nobody can claim that every one of those jobs was due to tax reform, but getting the climate set right as it relates to job creation is key, and particularly for creating jobs in this country.

So my question for all of you is, given that Ernst and Young study and the prevalence of these pass-through entities, doesn't tax reform have to be comprehensive—covering both individual and business taxpayers—in order to provide real tax relief to the overwhelming majority of Americans?

Let us just go right down the row, and we can start with you, Mr. de Hosson.

Mr. DE HOSSON. Thank you, Senator. Very briefly, because I can only comment from a European point of view and give you my initial views on that, I think that, indeed, it must be comprehensive. You cannot leave alone a part of the business the way business is carried on.

Restructuring the other side of it, there will be an effect from one side to another. It, I would expect, is inevitable. You have to—coming from a European background and my experience there—it has to be comprehensive. Yes.

Senator WYDEN. Very good.

Mr. Warren?

Mr. WARREN. I agree that tax reform would have to be comprehensive, in part because the effects of our current system depend on the interaction of those four rates that I talked about before.

But I would go even further than you did to say that tax reform—business tax reform, since we are talking about tax reform with entities and investors—also implicates other kinds of investors like tax-exempt investors, charitable endowments, and pension plans.

Imagine a proposal that would, say, let us dramatically reduce the corporate tax rate and make it up by increasing the top individual rate on dividends. That would have a certain distribution, as you suggested, between individuals and the companies.

It would also have very strong positive effects for investors who happened to be exempt, because they would benefit from the reduction at the corporate level and would not bear any of the burden.

So I would say even they have to be brought into the mix, and that is also true of foreign investors. So I think, absolutely, you have to think about all of these possible combinations.

Senator WYDEN. Thank you.

Mr. Trier?

Mr. TRIER. What you have just said is obviously one of the core points I discuss in my testimony. And the way I think of it a little bit is, by use of the base-broadening revenue—and I would not be comfortable, for reasons I go into in my testimony, with a world that would use the base broadening to sock it to me, so to speak,

while you lowered and reformed and made more rational the corporate-level rates applicable to public corporations, but on the other hand, you reintroduced a significant disparity between that pass-through world, the individual world.

It may very well be that, at the end, we have to live with some disparity, but I think we have to look at the process jointly or we have not accomplished much in neutrality.

Senator WYDEN. Mr. LeFrak? Last word for my round.

Mr. LEFRAK. Everybody would agree that comprehensive tax reform at the corporate and individual level is important. However, I would want to caution you about 1986 in one respect.

In 1986, tax reform did wreck the real estate industry in the United States, which was one of the major reasons why we had an S&L crisis. And, given that we are in a position of financial and job fragility in the United States right now, where our financial sector and our job sector are both hurting, I think that all types of tax reforms have be very, very considered and measured, and 1986-style reforms might, in some way, be playing with matches in this environment.

Senator WYDEN. My time has expired. I would only say I think, yes, this is a very different time in terms of real estate and housing than you had in the 1980s. And, as you know, Senator Packwood was one of the key architects of tax reform, from my home State.

I just think one of the big challenges is, as you look at this question, business, if you do not bring in all sides—and, as you know, there are a lot of groups here in Washington right now that are advocating corporate only, and a number of you expressed it—I think you are not going to get relief to the overwhelming majority of Americans, and that was the linchpin in 1986. The overwhelming majority of Americans, all the people who work hard and play by the rules, got real tax relief, and I just want to make sure we get that done.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman. Let me thank you for the hearing, and thank our witnesses.

I agree with much of what has been said. I come to this hearing agreeing with a lot of what Senator Hatch said about the concern of eliminating or restricting pass-through entities. I have been working to strengthen the ability of pass-through entities for two major reasons.

One, I do believe we have double taxation, and that is wrong. And, if you can set up business entities that can take advantage of one level of tax, I think it is the right thing to do. And secondly, it has encouraged the type of economic activities that many of you have talked about.

In my own State of Maryland, these entities have been responsible for a lot of our real estate and economic expansions. So I am reluctant to want to put the pass-through entities at a disadvantage.

I understand a lot of the discussions that have taken place, but I think Senator Wyden, in his questions, really raised a funda-

mental issue. I hear a lot about trying to spread the tax burden on the corporate side in order to get a lower corporate rate.

On the other side, we have to have more revenue in order to balance the budget. So you have to find revenue someplace. And, if it is not going to come out of the corporate sector taxation directly, then the individual taxes are going to have to yield more revenue. So I think it is unlikely that you can reduce the corporate tax rate and, at the same time, have a relatively similar marginal top rate on the individual side. I just think it is going to be difficult to get to those lower levels.

So I guess I want to try to isolate this a little bit. If the price for a lower corporate tax, in and of itself, without other tax reform, is to eliminate the pass-through entities, is that a good deal or not? And there would be other things that would have to be eliminated.

I think that the rate that people are talking about is 25 percent to get there. And I know, Senator Crapo, you were involved in some of these issues. You have to look at eliminating all of the tax expenditures and credits. At least 80 percent, I think, was the number that was given. So it would involve eliminating a lot of tax benefits and, also, answering questions like, what we do with depreciation and maybe the domestic manufacturing deduction in section 199, maybe interest deductions, things like that.

But, if we could just isolate those two changes. If we were to get a lower corporate rate, and the price of that was the elimination of these pass-through entities—and we have a lot of different types, and some are not called pass-through entities as such, but they are taxed at one level rather than two—bringing that into the corporate rate, is that a good deal or not, if we do not get beyond that? Who is brave enough to take on that question?

Mr. TRIER. Much of what you said is really what I have been thinking about. I am, in honesty, skeptical that we can get to a 25-percent across-the-board rate and, therein, a pass-through effect.

I like the way the pass-throughs work. So, in my view of the world, what I think is going to become necessary as you proceed is sort of a very delicate balancing of possible minor distortions, but with the objective that we have business income at all levels, pass-through or not, subject to a relatively modest burden. And so the last thing I would want is for pass-throughs to be brought into the corporate world and then have a huge individual tax rate.

In my testimony, I use the example of 40 and 28 percent. I do not think that is a forward movement. And where I may be more concerned is, we have to keep the world that is inhabited by the LeFrak Organization, et cetera, relatively close to the corporate world. It does not have to be identical, but, like what Senator Wyden was articulating, I do not think we can look at this as only something that is occurring in the corporate world and we take it out of the hide of the pass-through world, or tax poor individuals, like myself, from New York City.

Senator CARDIN. I think I would be very reluctant to give up the pass-throughs in what might end up being the tax policy of this country.

Mr. LEFRAK. I would just want to add a couple of things because, like New York, Maryland is a State with a high State income tax. That has been written about recently.

When you have the——

Senator CARDIN. I think you have higher taxes than we do, but we will——

Mr. LEFRAK. I think we do. So I think we are almost 12 percent, New York City, but Maryland is pretty high. But when you are paying in the corporation and then you are paying at the individual level again, you are now paying very, very high marginal rates of taxation to the point where people in Maryland who would be forced into corporate form would be working more days of the year for the government than for themselves or for their capital or for their families or for their futures.

And to take domestic American partnerships, which are here creating jobs in America and employing Americans, working for Americans, and to put them under the knife to make multinational corporations, put them in a different situation, I think that you have to decide where is the locus of the business activity that is represented by these partnerships and where is the locus of the business activity represented by these multinational corporations. And I think you have to take a home team-type of approach.

If multinational technology companies are opening up offices in Ireland and they are complaining about the rate of corporate tax in the United States, whereas Maryland real estate people are opening up businesses in Maryland, employing construction workers in Maryland, and putting people to work in Maryland, that should be a very, very different set of tax facts that this committee would approach, in my opinion.

Senator CARDIN. And I would just add one other thought to that, and I will yield back my time.

From the European example, one of the risk factors, if we eliminate pass-throughs, even if we have lower corporate rates, is, with the individual income taxes being what they are in our country, including local—and I think you were making a good point about the State and local taxes—you run the risk of using the corporate structure as a shelter through deferral, therefore, avoiding taxation. It does not get us the revenues that we expected to get, creating a problem.

So I appreciate particularly what Senator Wyden said about comprehensive reform. We are all for that. But we have to be realistic as to what is likely to happen here, and we have to be very careful if we are going to go to double taxation as the solution to our problems.

I, for one, am very concerned about movement away from or making it more difficult for pass-throughs.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I am just curious if any of you know the relative taxation of businesses in Europe, with European businesses compared with American businesses, irrespective of the form of taxation, just the burden. Is it comparable, or is there a difference?

Mr. DE HOSSON. I am sorry?

The CHAIRMAN. Is it comparable, or is there a difference? The burden of business taxation of European companies versus American.

Mr. DE HOSSON. Well, it is difficult to say, because we are not only discussing here rates, but also the tax base. The rates, if you are talking effective taxation, my guess is that, in most European countries, the burden will be lower on the corporate entities and such than in——

The CHAIRMAN. I know it is hard; I am generalizing. All businesses in Europe, just the burden, taxation burden on businesses in Europe compared with the U.S.

Mr. DE HOSSON. I guess it is lower. That is because——

The CHAIRMAN. Lower in Europe.

Mr. DE HOSSON. It is lower in Europe because, let us not forget, our basic revenue-raiser is the VAT.

Mr. WARREN. If I could just add one comment.

The CHAIRMAN. Yes.

Mr. WARREN. As you say, Mr. Chairman, it is very difficult to generalize. But I think probably, overall, at the business level, it is lower, but at the investor level, it is higher, because personal tax rates are higher. And we have to think about both together.

Mr. TRIER. Individual rates are higher in general. It is not just the investors, but it could be a lawyer or something.

The CHAIRMAN. Right. Now, is that a concept that the three of you think we should pursue, tax the individuals a little more, tax the businesses a little less?

Mr. WARREN. That is beyond our pay grade.

The CHAIRMAN. No, no, no. Our goal is competitiveness.

Mr. TRIER. As I have emphasized, I am not averse—let us use numbers. Let us say we ended up at 28 corporate level or 30 percent corporate level or entity-level business taxation, and there was an incremental 5 or 6 percent that, despite Senator Hatch's best efforts, despite Senator Crapo's best efforts, that little disparity remained, I think we have still done something positive.

But, if the result was that we took everything and went to 40 or 45 or 50 and—as somebody who lives in New York City and, by the way, checked out Maryland, the State tax, just in case; you have to take into account the State burden—I think that what ends up happening is, you have too much un-economic planning between whether you are using the entity that has the lower rate, you are doing something in a pass-through, doing something in a corporation. So I just do not think it is right to go in that direction.

The CHAIRMAN. Let me ask Professor Warren to amplify on an earlier answer. He was asked, I think by Senator Crapo, all of you were, the degree to which you tend to agree with the concept that business income should be taxed similarly, irrespective of its form.

And you, Professor Warren, said, yes, we agree in principle, but when you start digging down into it, how that is accomplished, there are different paths, different approaches.

Could you elucidate a little more on a couple or three of those different paths and different alternatives that might make a little more sense compared with some others?

Mr. WARREN. Sure. Just to take sort of two polar extremes. Everybody is familiar with withholding on your salary. We could make the corporate income tax essentially a withholding mechanism. Corporations would pay taxes, but when shareholders got

dividends, they would receive a tax credit for their corporate tax paid with respect to that dividend.

That is essentially the system that the European countries had that Mr. de Hosson talked about. That is no longer possible in Europe because of the European treaties, which do not apply to us. So it would be perfectly possible here.

That would mean that your income that was earned through corporate solution would be taxed ultimately at your individual rates, because, when you get the dividend, you pay your rate and you get a credit for what the corporation paid for.

The alternative is to say, we just will not tax individuals at all. We will have a flat rate at the company level. We will collect it always.

The CHAIRMAN. Flat corporate rate.

Mr. WARREN. Flat corporate rate, or whatever entities we are applying the rate to.

Mr. TRIER. We will not tax individuals on business income. Right?

Mr. WARREN. We will not tax individuals on business income. Right.

The CHAIRMAN. Just tax the business.

Mr. WARREN. We will just tax the business at some rate. And the Treasury Department once proposed a so-called comprehensive business income tax that would do that. And in 2003, the administration proposed exemption for dividends at the shareholder rate.

So those are two different pathways. They are very different. The first one would apply your usual graduated rate ultimately to your income, and the second one would single out, for a particular rate, business income.

The CHAIRMAN. Do you lean toward one of the two more than the other?

Mr. WARREN. My own personal view would be to lean toward the first, again, on the grounds of simplicity. If people are subject to more than one tax rate, their own individual rate on things that are not earned through businesses and a different rate on things that are earned through businesses, that is just going to compound game-playing, people trying to transform one form of income into another. That would be my reasoning.

The CHAIRMAN. My time has expired. But very briefly, Mr. Trier, is that a concept that you find outrageous, or is that something you can handle?

Mr. TRIER. No, no, no.

The CHAIRMAN. There may be something to it?

Mr. TRIER. I generally agree with what he has said. I want to say this, even though it is a long story, it kind of is responsive to Senator Hatch's questions earlier.

I find myself in somewhat more sympathy with the taxing it once at the entity level as opposed to the approach of Professor Warren. But reasonable people can disagree and et cetera.

The devil is in the details and, therefore, to go back to this treatment of pass-throughs—and the proposal is sketchy, whatever you call that structural thing that the administration put out—I am not, in principal, against there being sort of a uniform entity tax level.

The devil in the details is whether you end up with full tax, a relatively significant—I say 35 percent or 30 percent—rate at the entity level and then this significant additional layer of tax that is imposed somewhere along the line on that business income.

I think that that reintroduces the distortions and moves us toward a double burden of tax in a way that is just not where we should be going. It is not where we should be thinking about it.

The CHAIRMAN. My time has expired. But this concept that the form of income is irrelevant, whether it is cap gains, dividends, corporation income, or other business income—you add it all up, and it would be one tax.

Mr. TRIER. One tax or barely more than one.

Mr. WARREN. If I could just make one interjection, Mr. Chairman.

Doing it at the company level is a little harder today than it was in the past because of international competition, where, because European rates are so much lower and so on, if you went down that pathway, you might find yourself more constrained in terms of what you can do. It is just a different consideration.

The CHAIRMAN. Right. It raises lots of questions. But my time has expired.

Senator Hatch?

Senator HATCH. Many countries have a territorial system as well, which we do not have, which I think is tremendously disadvantageous to us. You can go on and on about the differences, it seems to me.

This question would be for you, Professor Warren. In your testimony, you note that Treasury, in 1992, introduced a comprehensive business income tax prototype that would apply to all business entities, whether formed as a corporation, partnership, or limited liability company.

Now you advocated, as I recall, in 1993 and continue to advocate today, I believe, for a shareholder credit for corporate taxes paid. Now, would you recommend one regime in which an entity-level tax is imposed on all business entities and then a shareholder credit is used to eliminate the double tax on earnings, or would you establish, say, two regimes in which a dividing line is created between taxable entities and pass-through entities and limit the shareholder credit system to the taxable entities?

Mr. WARREN. Obviously, the fewer distinctions we can have, the simpler our system would be. On the other hand, I certainly think about small businesses, which we may not want to ask to go through the complexity of having a withholding at the entity level.

So my instinct would be, if we were going down this pathway, to try to transform the corporate tax into some sort of withholding tax. My instinct would be to limit that to all business entities that were large—obviously, there would be a question as to what that means—and to let smaller entities continue with the pass-through.

But I think that is an important and difficult design question that you raise, Senator.

Senator HATCH. Thank you. Well, we would like to have your best thinking on it beyond what you say here today.

I have other questions, but I think Senator Carper is here.

The CHAIRMAN. Senator Carper?

Senator CARPER. Thanks, Mr. Chairman. And welcome.

I apologize for not being here. We are trying to pass some cybersecurity legislation to safeguard our country and help us on our national security and on our economic security, and I have been over on the floor working on that.

We appreciate you and your comments and your willingness to respond to our questions.

One of the main reasons we hear that tax reform has again become necessary is the proliferation of new tax breaks added, some of them since 1986, some of them more recently than that, to the tax code. We do it every year, as you know.

Also, one of the other reasons is because of the increased use of some of the existing tax expenditures by taxpayers. I am told by the chairman of the Budget Committee that, if we add up the cost of these tax expenditures, the total of them over the next 10 years is about $15 trillion, which I believe is more than we are expected to appropriate over the next 10 years.

So we figured out a new way to move money out of the Treasury, not by appropriating money, but through the tax code. But some of the tax incentives for individuals and for companies, I think, are sound policy. Most would say that that is a good idea, we should do more of that.

With that in mind, the tax treatment of debt versus equity is something that I feel needs to be examined and needs to be examined closely. Particularly, we are discussing whether or not to better integrate the corporate code and the individual tax code.

I would just like to ask each of you, it may take a minute, to directly and frankly tell me and others who are here today which type of integration system you think would be more effective. Are there any that reduce any bias in favor of debt that are in the current tax code?

And I do not care who goes first. Start with the youngest.

Mr. LEFRAK. Just completely offhand, I think that if one would be concerned about people receiving interest payments and inappropriately not paying tax on the receipt of those interest payments, then we should have a withholding tax on interest income.

If one decides that the recipient of that interest income is worthy of receiving that income without paying taxes, credit back the withholding. And if one finds that the recipient of that interest income should be paying tax on the receipt of that interest income, then keep the withholding.

If one buys Swiss government bonds, for example, the Swiss government—even though they pay a meager rate of interest, which is now negative—they actually withhold interest and they keep it to themselves, and if you are a worthy owner of those government bonds, you can apply to receive that interest back.

So I think one idea that came out of this discussion with the three erudite tax professionals—whose tax erudition exceeds my knowledge by many years and many volumes of books—what I would say is, think about a withholding tax on interest payments to make sure that the person receiving that interest payment is appropriately being taxed on that payment.

Senator CARPER. All right. Thank you.

Please, others?

Mr. DE HOSSON. Maybe in general, in Europe, here in the States, there has been a lot of discussion about debt-to-equity ratios, earnings strippings, what have you. Almost all countries have that now in place.

An interesting discussion is that the bias is reduced by allowing the deduction of undeemed return on equity. That is what Belgium has done, and there is some serious discussion about that in my country.

Senator CARPER. Thank you.

Mr. WARREN. Just picking up on what Mr. LeFrak said, if we had a withholding tax on interest, that would be an exact parallel to having a shareholder credit form of integration, because the shareholder credit performs exactly the same function as the withholding tax.

My direct answer to your question would be that the shareholder credit form of integration would be the most direct way of eliminating the distinction.

I would caution the committee against another pathway, which is, since interest is deductible, some would say, why do we not just make dividends deductible, which would eliminate the corporate tax when the dividend was paid?

The problem with that is that that would eliminate the corporate tax for certain kinds of recipients who themselves are not taxable. And so that is why I would prefer the shareholder credit approach.

Senator CARPER. Thank you, sir.

Mr. TRIER. I will say briefly that I think it comes—I agree with what Professor Warren just said about the deduction system, unless you somehow made them taxable on that at their entity level. There is a recent article in *Tax Lawyer* to that effect. So it has been going on for 20 years, whether the base place you get taxed at once is at the entity level or whether it is through the credit system.

The point that I would make that makes things a little bit more complex here is that the integration systems, which I think Professor Warren and I would agree come down to two basic versions, do not fully address debt and equity.

They address debt/equity distinctions of the type that we are accustomed to talking about, the stuff that I did on Wall Street for 20 years, designing things to get debt treatment where maybe it was really equity. There is still the interface with those non-taxed parties that you have to deal with.

Therefore, you have to—maybe you deal with it exactly as you have it today, but you still have some remaining disparity between equity and debt if you simply keep the basic deal that we have with foreign taxpayers and U.S. taxpayers today.

I do not know whether Professor Warren agrees with me or not.

Mr. WARREN. I agree with you.

Senator CARPER. Terrific. Thank you all very, very much. Thank you.

The CHAIRMAN. Thank you, Senator.

I think it was Wayne Gretsky, when asked why he was such a great hockey player, said, "You don't skate to where the puck is, you skate to where the puck is going to be." Just like the Babe Ruth quote.

We are thinking ahead about where this country is going to be from a business perspective 5, 8, 10, 15, 20 years from now, to the degree that one can.

The trend is, we have more high-tech and services and so forth, and more globalization. So, as we address this question, what are the couple of things we might be thinking about, from your perspective, to make sure we are making changes that make sense, not just for today, but kind of planning ahead a little bit, or can we?

Mr. WARREN. I think we can do the best we can, and I think the committee is absolutely to be commended for having this series of hearings on these kind of fundamental issues so that the committee will be ready to think about fundamental reform when it becomes politically possible or germane.

I guess my advice, for what it would be worth, is to continue down the pathway that the committee is on, which is to try to think about ways to rationalize the taxation of American business income through different business entities, whatever those entities may be, to reduce the tax incentives to structure investment in different ways.

Mr. TRIER. I would add to it. It is, of course, exactly what is making our job so hard, that the overall level and rationalization that we come up with has to be consonant with what is going on in the world. And this, as mentioned by you at the inception, this whole effort on business entity taxation is very, very linked to the international—whether it is territorial or other—system.

So I actually think I know where we are going. I think that things have played out in a way that we tend to know what this modern world looks like now, and I think we have to come away with a balanced system that is relatively rationalized, that, nevertheless, permits us to continue to be the best place in the world.

The CHAIRMAN. Some commentators think our country is a little too heavily involved in consumption, maybe biased toward housing looking toward the future, with not enough investment in education, enough investment in infrastructure, to help make us competitive with other countries worldwide.

So, as we reform the code, I can support, not just how to integrate and so forth and how much rates can be lowered compared to the base-broadening, et cetera, and all that. But it is an opportunity to kind of look and see the degree to which the code can have any effect, help encourage our country to be economically stronger through more investment in some of the basics—education, infrastructure, entrepreneurship, and so forth—so our kids and our grandkids have a better shot than they otherwise might.

Do any of you have any thoughts on that subject?

Mr. WARREN. I would say one thing, Mr. Chairman—and I completely agree with your comments. And that would be, as you think about, as several of the members have said, how to pay for some of these proposals——

The CHAIRMAN. That is right. That is a big question.

Mr. WARREN [continuing]. One of the parts of the code that I would urge you not to attack is the incentives we give for research and development, which are fundamental for the future of the country, and I think have been influential in that regard. Part of

the outstanding part of our economy today is that so much has been developed in the past in basic research and development.

The CHAIRMAN. I agree with that.

My time has expired.

Senator Hatch?

Senator HATCH. Let me just say that I agree with you, Professor Warren. I think both of us do. The R&D tax credit is an approach that I would like to make permanent.

The CHAIRMAN. We both do.

Mr. TRIER. It turns out you guys are not in charge anyway.

The CHAIRMAN. Well, it is a snare and a delusion. [Laugher.]

Senator HATCH. Our problem is that we have really one of the stupidest budget processes that I have ever seen in my life, and you might want to give some thought to that too, to help us down here.

But I particularly have enjoyed this panel very, very much. We have a top businessman, we have top tax experts, we have a top European tax expert. I mean, it does not get any better than that.

So I am grateful to all of you. Thank you for being here.

The CHAIRMAN. And I also thank you very much. You have taken a lot of trouble to draft your testimony, come to Washington, DC. We deeply appreciate your help. This is, as I said at the outset, a subject we think is very important and somewhat at the heart of tax reform.

We will be talking to you more, I am quite certain of that.

Senator Carper?

Senator CARPER. This is not a question that I am going to ask you to respond to here.

Sitting behind me is Chris Pendergrass, my tax counsel. He has done a lot of work. He reached out to a lot of folks and asked for comment on this and input on the R&D tax credit, and it is universally supported—almost universally supported, as you know.

The question is, is it perfect? Probably not. Can it be made better? It probably could, and we have an opportunity here to ask that question and try to answer it.

I am going to submit a question along those lines in writing and ask that you would respond. If we are going to make some changes that can make it more effective for us going forward, what changes would you suggest? If you could get that question and respond to it, I very much appreciate it.

Thanks for joining us today.

The CHAIRMAN. And I am sure you all know this, but the many high-technology companies, they say, lower the top corporate rate. They say they are willing to get rid of all these tax expenditures, just get rid of them, get rid of depreciation, get rid of the R&D tax credit, get rid of the section 199 deduction, get rid of them all. That is what they say, and I am not too sure how many actually believe that.

But the top, larger U.S. tech companies just say, get the rate down to 26 percent, something like that, we do not care about any of the rest of that stuff. And that is for a larger company in the high-tech world. That might not be as true in some other companies.

But I agree with the point of Professor Warren about R&D. I think there should be incentives for research and development in the United States.

Mr. LEFRAK. I would like to, in response to that comment, just state that this is the United States Senate, and this body is charged with the well-being of people in the United States, and companies that have chosen to incorporate in the United States are very, very different from domestic businesses. And thinking about how one balances the equities of taxation, I think that it is a very important thought going forward. We need to think about what incidence of taxation are we imposing on companies that are incorporated in the United States versus domestic American businesses that are entirely within the United States.

The CHAIRMAN. Correct. That is a very good point.

Mr. LEFRAK. And I think that that is a very, very important point as it relates to this concept of taxation of partnerships, because we are getting into this tension of businesses which hover over the United States, which are incorporated here, potentially, wanting to have their taxes reduced and wanting to have domestic American partnerships pay the price for businesses that are not fully domestic and fully American.

I just think that that is a very, very important point that we have to make, and I would just like to bring that out on the table in case anyone was too polite to bring it up.

The CHAIRMAN. I am glad you brought it up. Thank you.

Senator Menendez? We are joined now by the Senator from New Jersey. Thanks, Senator.

Senator MENENDEZ. Thank you, Mr. Chairman. I am glad to be able to get here before the hearing closed. I was chairing my own hearing on housing, but I wanted to get here.

I appreciate the testimony the panel has given, particularly the written testimony that I read, and I want to welcome Mr. LeFrak to the hearing.

The LeFrak family has really transformed the Hudson waterfront, which was abandoned railroad yards, legacies of failures of the past, many of the sites contaminated, lying fallow without creating any ratable economic opportunity or housing.

The vision of Mr. LeFrak's grandfather, followed on by his father and his family, transformed the whole Hudson waterfront, in which now—and I would welcome the chairman and the ranking member to come visit anytime—you would see an incredible vibrant community of housing, real estate, commerce, commercial real estate, parks, a real vibrant sense of community, an enormous ratable base, and an unlocking of economic opportunity.

I wanted particularly to come here and recognize that. And I see that, in your testimony, you very strongly oppose taxing large partnerships as corporations. In fact, you state that your family would stop building and stop taking risks if such a proposal became law.

I am wondering, in the context of having set the framework of what has been unlocked in the case of the Jersey City waterfront, among others, do you think that if the tax policy were different, that those investments would have been made, the ones that your family made and transformed that waterfront on?

Mr. LEFRAK. Currently, we pay a rate of taxation that exceeds 50 percent. So it is not as if we are not willing to do business and take risks and pay a heavy tax burden. A 50-percent-plus tax burden is, in my opinion, a very heavy tax burden. And globally, our European tax expert would tell you that it is among the top of the world.

Having said that, if our tax burden were a 75-percent-plus tax burden, where we would be working 9.5 months for the government before we started working for ourselves, which would put us kind of until mid-September as, let us say, a government program and then a private enterprise between mid-September and the end of every calendar year, I think we would seriously consider whether we should be taking risks at that time, whether it was worth spending time at work or whether we should just be coming down to Washington and enjoying our Nation's monuments, parks, and other cultural activities that we as taxpayers have been fortunate enough to fund.

Senator HATCH. You can only take so much of that, you know. [Laughter.] But we get your point.

Senator MENENDEZ. The other question I have is maybe not the focus of the hearing, but I certainly want to use your expertise on it. When we were talking about the treatment of family partnerships and carried interest as it relates to real estate, where there was a huge concern of the consequences of the changes that were being proposed in that, I would like to get a sense from you what would have been the consequences in your own experience had that become the law at the time.

Mr. LEFRAK. Well, the law, as written, created a tax burden for real estate family partnerships. That was the same tax burden for real estate partnerships where the capital was being promoted against investors.

What was particularly troublesome about that legislation to my family's enterprise was that my family's enterprise, which does not receive $1 of carried interest from any investor whatsoever, was being taxed under that legislation as if it were a business that raised money from investors and as if it received a carried interest from those investors.

So I am not in the world of carried interest, and I do not get carried interest, but I was going to be carried out by carried interest. [Laughter.] And I was particularly troubled that the revenue score of that bill reflected all of the family businesses, like ourselves, which would have been carried out with carried interest, even if we did not receive $1 of carried interest on any type of investment or any type of partnership that we participated in.

So that was really where my trouble with that legislation arose, and I was happy to communicate it to you at the time, and I will be happy to communicate that to you at any time in the future, sir.

Senator MENENDEZ. I am sure you will.

One final question, if I may, Mr. Chairman.

Mr. Trier, you wrote, "I am deeply skeptical that we can achieve, consistent with fiscal responsibility, the more ambitious goals that have been publicly announced," and you note a 25-percent corporate tax rate as an example.

In your opinion, is it realistic for a tax reform package, done in a revenue-neutral manner, to achieve a 25-percent corporate tax rate? And what do you think of the significant issues surrounding whether or not that is achievable?

Mr. TRIER. We discussed some of them before you came. But I am, in fact, skeptical that we can achieve a 25, 28, something like that, percent rate at both—let us say 25. I am very skeptical that we can achieve that rate, consistent with the political mission that we have, in a manner that is relatively neutral across the public corporation world, the world that Mr. LeFrak inhabits, and the world that I have done a lot of work in, which is the closely held business.

The burden in my testimony is that the thing that I really do not want to see is having us finance 25, 28, name your number, for the larger multinational enterprises in a manner where we are, in effect, subjecting other sectors of the economy to 38 or 40 or too high a rate. So the key to me is that, as this process goes forward, there is relative balance in how we approach the system.

Now, this sounds a little bit like a Republican approach to the whole system. I am not so concerned that there be absolute parity between the rates across the board, but I would think it would be unfortunate if we would finance getting to that 25 percent on the backs of the non-corporate and non-public sectors of the economy.

Senator MENENDEZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thanks, all of you, very much. I appreciate your time.

The hearing is adjourned.

[Whereupon, at 12:30 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Tax Reform and Business Entities
As prepared for delivery

Baseball great Babe Ruth once said, "Yesterday's home runs don't win today's games."

The same is true in our modern economy. Businesses have to be responsive to the changing landscape around them.

Today, that landscape offers many different pathways to success. For example, that success could come through an IPO, private investment or by forming as a pass-through.

For some businesses, the ultimate success is the IPO, or initial public offering. This is when after months or years of hard work, a business debuts as a publicly-traded company.

Once believed to be the best route forward for growing a business, IPOs are becoming less and less common. In the 20-year period from 1980 to 2000, nearly 300 U.S. companies went public each year. In this past decade, however, the average fell to 90 companies per year.

Fewer businesses are filing their taxes as C-corporations, which are taxed separately from their shareholders. That number has been falling at a fairly steady pace for the past 25 years, from a high of 2.6 million corporations in 1986 to 1.7 million in 2009.

But even with fewer IPOs and C-corporations, the total number of businesses has increased steadily over the past 20 years.

Why are more and more businesses avoiding stock markets, once seen as the pinnacle of business success?

Today, a business can obtain the capital they need to grow through a variety of sources including private equity, venture capital and private placement. In addition, many businesses may want to avoid the higher taxes that come with listing on established stock markets.

Today, 95 percent of all U.S. businesses are structured as so-called pass-through entities — which are partnerships, limited liability firms, sole proprietorships and S-corporations.

Originally used primarily by small businesses, recent changes in the law have made it easier for medium and large businesses to be taxed as pass-throughs and still retain the benefits of limited liability.

The pass-through structures give businesses unique tax incentives that might discourage companies from accessing stock markets. Pass-throughs don't pay corporate taxes; their business income is taxed at individual income tax rates.

However, C-corporations get taxed on income, and then — when that money is distributed in dividends to shareholders — it is taxed again.

While a valuable tool for small businesses, we should examine if the use of pass-throughs have disrupted the level playing field for larger non-public companies and their public competitors.

Ideally, our tax code should cause as few distortions in business as possible. Businesses should plan and organize based on growth and job creation – not the tax code.

One of my main goals of tax reform is to make the system more competitive, but also keep it fair.

Our hearing this morning will examine the difference between corporate and pass-through taxation and whether current rules strike the right balance in our diverse economy.

Today we will explore various proposals to reform our tax system, ranging from the idea of creating one business level tax through some method of integration to proposals to treat large pass-throughs as corporations.

We will also discuss more tailored changes. That could mean simplifying the complex ways the tax code treats different pass-throughs, or simplifying the audit process of large pass-through entities.

Many businesses have urged Congress to enact corporate tax reform, arguing that the United States is out of step with international rates and methods of taxing foreign income. It is important for us to compare how all forms of business are taxed internationally. We will discuss that today as well.

Recently, I outlined four goals that must be at the heart of any tax reform plan. These are the creation of jobs from broad-based growth, competitiveness in the world markets, innovation and opportunity.

Whatever changes we make to the corporate tax code must result in a more efficient system. We want businesses focusing their energy and resources on growth and jobs. I look forward to discussing these issues today.

So let us remember that for entrepreneurs, the American dream is to create an idea, build a business and then watch as the hard work and sacrifice turn to success.

Let us remember Babe Ruth's words, and remember that yesterday's home runs won't win today's games. And let us build a tax code that works for today and tomorrow.

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Testimony of Fred C. de Hosson, Partner, Baker & McKenzie,

Amsterdam Office, The Netherlands

Before the Senate Committee on Finance

Hearing "Tax Reform: Examining the Taxation of Business Entities"

Testimony: "Introduction into the Western European tax systems and the choice between taxable corporations and tax exempt pass-through entities"

August 1, 2012

Good morning, Chairman Baucus, and members of the Committee.

I appreciate the opportunity to be here today to discuss the taxation of business entities and especially the question why -compared to the United States- relatively little use is made of pass-through entities for regular business ventures in most Western European countries

I see four possible reasons:

1. In some jurisdictions, the less defined legal position of pass-through entities with respect to legal ownership and protection against liabilities is a major obstacle for their use as business entity;
2. The international environment wherein most European businesses operate requires more certainty with respect to the tax and legal treatment of the entities by the countries involved;
3. The relatively low corporate tax rates in Europe as compared to individual income tax rates make the use of corporations more attractive; and
4. The availability of tax facilities for corporations as a result of EU direct tax measures makes corporations the most suitable entities for expansion in the EU internal market.

I will discuss these reasons now in more detail.

1. The less well defined legal position of pass-through entities in certain countries.

There exists a wide variety of entities treated as pass-through vehicles for tax purposes in most European countries. The most well known are the (limited) partnerships. In some countries legal characteristics of these entities may make them unsuitable for ordinary larger businesses. In The Netherlands, for instance, a partnership lacks legal personality and can as such not hold title to assets of the business. A corporate entity has a separate legal personality and offers the advantage of the ability to hold legal title. In The Netherlands, this type of entity is normally more attractive to investors and entrepreneurs than an entity without these characteristics. It should be noted that the legal position of entities normally considered as pass-through entities is quite different in each of the European jurisdictions and in some jurisdictions the described disadvantages may not or to a lesser extent exist.

2. The international environment for European businesses requires tax and legal certainty on a cross-border basis

The environment wherein European and US businesses are set up and expand is fundamentally different. The economy of the United States is the world's largest national economy with a GDP that was estimated to be over US $15 trillion in 2011. It is true that the economy of the European Union generates a GDP that is over US $17 trillion. However, that internal market for goods, capital and (to a lesser extent) services, is still carved up by the not-completely harmonized tax and legal systems of 27 different member states. Most small and medium sized US enterprises can for an extended period expand in the US market only, while many small and medium sized European enterprises, already at an early stage of their expansion, must invest in multiple jurisdictions throughout the European Union and face the consequences of the application of foreign tax and legal systems.

Since pass-through entities may face a different tax treatment in other jurisdictions, doing business internationally through these vehicles may bring uncertainty with respect to the tax treatment as compared to the use of a straight forward corporate vehicle.

The following is a brief summary of the tax uncertainties with respect to pass-through entities used for cross border investments or the raising of capital.

Different Classification in Different Jurisdictions

The most complicated issues arise if an entity is classified for tax purposes as a corporation in one jurisdiction and as a partnership in another jurisdiction, leading to completely different tax results. Even if a jurisdiction classifies an entity the same way as another jurisdiction, the tax treatment may still differ. This well known issue occurs when one jurisdiction treats a partnership as a transparent entity, imposing no tax on the partnership itself, but on its partners, while the other jurisdiction treat that partnership as a taxable entity, taxing the partnership as a corporation.

There are many other examples that result in double taxation because of these differences in classification and tax treatment. For instance, some countries may accept that a partner may also be a creditor of the partnership and may therefore derive interest income from the partnership, while other countries consider that no interest may be paid to a partner, and any payment of what purports to be interest is treated as a distribution of the income of the partnership.

Classification Issues under Tax Treaties

When a business is operating in several countries (and therefore subject to different tax systems), another important issue with respect to the use of pass- through entities is the applicability of tax treaties.

The issue of applicability of the tax treaties to fiscally transparent entities is widely acknowledged. Tax treaties generally only apply to persons who are residents of one or both of the contracting states. In the OECD Model Convention, used as model for most bilateral tax treaties, a person is defined as 'an individual, a company and any other body of persons'. A company is defined as 'any body corporate or any entity that is treated as a body corporate for tax purposes'. In other words, if a non-corporate entity is treated as a body corporate, it will qualify as a person. In its Partnership Report published in 2000, the OECD finally confirmed that a partnership should be considered a person within the meaning of the OECD Model Convention. However, the position of other non-corporate entities such as trusts and other associations of persons is less clear.

Even assuming that all non-corporate entities should be qualified as persons within the meaning of a tax treaty, such entity should also be considered a resident of a contracting state in order to enjoy treaty protection. A resident is defined in the OECD Model Convention as 'any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of similar nature…'. It is generally accepted that 'liable to tax' does not mean that tax is actually levied; entities that are fully exempt from tax could still be considered residents, as long as that state could assert jurisdiction to tax the entity on its world wide income. However, if a partnership is considered as tax transparent

in a contracting state, the partnership is not liable to tax in that state and so cannot be considered a resident for purposes of the Treaty.

Taxable presence in the country wherein an investor/partner is resident

Should an investor/partner of a pass-through entity be resident of another country than the country wherein the entity is situated then, under the specific circumstances of a case, the entity may be considered to have a taxable presence ("place of business"; "permanent establishment/agent") in that other country.

3. Relatively low corporate income tax rates as compared with individual income tax rates.

In most European countries, personal income tax rates are significantly higher than corporate income tax rates. The use of a corporate entity allows for the deferral of the imposition of personal income tax until the business income of the corporation is distributed as a dividend or an interest in the corporation is sold (in the latter case a special capital gains rate may apply). The present value of the personal income tax will be low as long as the business is expanding and the corporation reinvests its profits.

Nevertheless it must be recognized that the income of the business is in principle subject to tax at both the corporate and the individual shareholder level. In the past a number of European countries mitigated this so called "economic double taxation" through the introduction of systems integrating the imposition of corporate and individual income taxes. For example, Germany introduced different corporate tax rates in 1953 for distributed (36%) and retained earnings (50%) The most well known of these integration systems are the "imputation systems" (introduced by France first in 1965, followed by the United Kingdom (1973) , Italy, Ireland and Denmark) allowing the shareholder to credit, in various degrees, corporate income tax paid by the corporation against his personal income tax liability with respect to dividends received. The problem with these systems in an EU context is that they tend to exclude foreign source income and foreign shareholders with respect to the granting of the imputation credit. The European Court of Justice (ECJ), in several decisions, found these aspects therefore discriminatory and a violation of the fundamental freedoms of establishment and capital movement enshrined in EU law as the backbone of the internal market. As a result most countries have largely abandoned these systems and fell back on the "classical system" wherein business income of a corporation is taxed at both the corporate and individual income tax level (albeit that in many countries special personal income tax rates apply for dividend income).

The resulting economic double taxation has, however, been mitigated as a result of a significant reduction of corporate income tax rates in almost all European countries. This reduction has been caused by a severe competition for investments between member states. Since the Single Market was completed by the end of 1992 (result of especially the 1988 Single European Act), substantial cross border investments took

place within the EU (and into the EU), and member states have competed for these investments by offering benefits, largely by reducing corporate tax rates. More focused tax benefits run the risks to be characterized as prohibited "state aid" or as being in conflict with the so called "Code of Conduct"). For instance the low Irish corporate tax rate of 12.5 percent is allowed but the tax facilities available for Irish "International Financial Services Centres" constituted State Aid (albeit declared compatible with the internal market by the Commission till 2006).

In other words, corporate income tax rates are currently relatively low, mainly as a result of this form of "tax competition" among the member states of the Union. Consequently, the double economic taxation attached to the classical system of taxation of corporate business income, as applied by most member states, has been significantly mitigated. Below is a chart that compares the highest tax rates for corporate income and personal income in six member states:

Jurisdiction	**Corporate income tax rate %(top bracket)** *investment through a corporation*		**Personal income tax rate % (top bracket)** *investment through a tax transparent partnership*	
Year	**1992**	**2012**	**1992**	**2012**
The Netherlands	35	25	60	45.76
United Kingdom	33	24	40	50
France	34	36.1	56.5	64.25
Germany	58.15	30.85	53	45
Ireland	40	12.5	52	48
Italy	52.2	27.5	51	43

Sources: "IBFD", "OECD 2010: Revenue statistics comparative tables, OECD tax database" and "1975-1999: World Tax Database, Office of Tax Policy Research"

4. EU law based tax benefits exclusively available for corporations.

As noted (see 2), a major difference between a US business and a similar European business is the fact that the latter operates in a market that to a large extent is single but nevertheless retains elements (tax, legal systems) of a combination of separate national markets.

However, especially in the tax area (but also in the corporate law area – the so called corporate law directives), a process of "harmonization" is taking place. This process is partly directly initiated by EU law and partly the result of tax competition among the member states.

The EU law initiated benefits concern tax facilities adopted in the legislation of member states on basis of EU Directives (a EU legislative instrument requiring member states to introduce national legislation with a content outlined in the Directive). The most important directives are the 1990 Parent-Subsidiary Directive and the 1990 Merger Directive. The first Directive reduces withholding taxes paid by a EU parent to a EU parent company to nil. The second Directive allows tax free mergers and reorganizations between EU based businesses. The facilities based on the Directives are only available to entities taxed as corporations (at the time of introduction – 1990 – only corporations; later, respectively in 2003 and 2005, extended to entities taxed as corporations). Consequently, for instance, a tax free reorganization of a cross border business carried on by corporations is easier to achieve than such business carried on by pass-through entities.

A degree of tax harmonization is also taking place as a result of tax competition. An example is the introduction of a territorial system of taxation by most member states. Originally The Netherlands and France were rare examples of countries exempting foreign source business income (dividends received from a foreign subsidiary) from corporate income tax (the so-called participation exemption in The Netherlands). Almost all member states have now replaced their "world wide" income tax concept by a territorial tax income concept. In other words replacing their credit systems with an exemption system (in some countries – Germany, Belgium, France, Italy, - 95% of dividends received are exempt). The UK was one of the last member states to introduce an exemption system for capital gains in 2002, extended to dividends in 2009. Ireland still holds out and applies a (severe) credit system.

There exist good arguments to claim that an exemption system for foreign source business income, emphasizing "capital import neutrality", fits better in with the internal market concept. It could even be argued that the complexity a credit system (emphasizing "capital export neutrality") usually brings is as such an obstacle to investments elsewhere in the internal market. It is, however, unlikely that the ECJ would find the application of a credit system to foreign source business income as such a violation of the freedom of establishment.

It is likely that tax competition for investments among the member states since the establishment of the internal market in 1992 has caused most member states to replace their credit systems with an exemption system. Countries applying a credit system are not considered a suitable base for a possible later expansion of a business to other member states of the Union.

It is noted though, that almost all member states, applying an exemption system in principle, do maintain a credit system with respect to controlled foreign corporations realizing "passive income" (e.g. interest income). The ECJ does allow in cases of "abuse"(no "substance"/"wholly artificial arrangements") members states to apply a credit system and even to tax the foreign income of these subsidiaries on a current basis in the hands of the domestic corporate parent company.

The combination of EU law based tax facilities for corporate cross border investments, reorganizations and mergers combined with the gradual introduction of territorial (exemption) systems by member states with respect to foreign source business income, is for businesses in Europe an important reason to prefer the use of corporations over pass-through entities.

This concludes my testimony and I would be happy to answer any questions you might have.

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STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF AUGUST 1, 2012 TAX REFORM: EXAMINING THE TAXATION OF BUSINESS ENTITIES

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today released the following opening statement at a committee hearing examining the impact of tax reform on American businesses and corporations:

There seems to be a lot of interest in corporate tax reform, which is understandable given that the top U.S. corporate tax rate of 35 percent is about ten percentage points higher than the average top corporate tax rate of the OECD countries.

But corporate tax reform should really be viewed as part of business tax reform, which is the subject of our hearing today.

As is well known to tax scholars and the business community, the earnings of a C corporation are taxed once at the corporate level and a second time at the shareholder level if the earnings are distributed in the form of a dividend. As a result, the earnings of a corporation may be subject to two levels of taxation, a system generally referred to as the classical system of taxation. For many years, the U.S. Treasury Department, the organized tax bar, and other interested parties have advanced a number of proposals to integrate the individual and corporate level of taxes.

It makes no sense today to have two levels of taxation of corporate earnings. In fact, I am not sure it ever made sense to have two levels of taxation even in the early years of our income tax system. Earlier this year, President Obama released his framework for business tax reform. One of the really bad ideas in there was to double-tax certain pass-through entities. Like all bad ideas, this one should be rejected. All business income, whether earned by a C corporation, a large pass-through entity, or a small business, should be subject to a single level of tax — either at the entity level or at the owner level. A big challenge in moving to a tax system in which all business income is subject to a single level of tax, which we should do, is that such a system may raise less revenue than the current system.

In 2003, Congress enacted preferential treatment for dividend income leading to partial integration of the individual and corporate level of taxes. Next year, an additional tax on capital gains and dividends is scheduled to go into effect. As part of Obamacare, the Democrats enacted a 3.8 percent tax on the net investment income of single taxpayers earning more than $200,000 and married couples earning more than $250,000. This was not indexed for inflation at all. With the scheduled expiration of the 2001 and 2003 tax cuts at the end of this year, capital gains will be subject to a 23.8 percent tax beginning in 2013 — a 59 percent increase from current law. Dividend income will be subject to a 43.4 percent tax in 2013 — a 189 percent increase from current law! The result would be a return to the classical system of taxing the earnings of a corporation with all the distortions that accompany such a system.

With a top corporate tax rate of 35 percent (coupled with an average four percent state corporate tax rate), the U.S. has the highest corporate tax rate in the developed world. The top

corporate tax rate should be reduced by at least ten percentage points to a maximum of 25 percent, which would bring the U.S. in close alignment with other OECD countries. The top individual rate should also be substantially reduced. Having both corporate and individual tax rates at approximately the same percentages coupled with corporate integration will achieve a large measure of parity in the taxation of business income, whether earned by a corporation, partnership, limited liability company or sole proprietorship.

We have a great panel of witnesses, and I look forward to hearing what they have to say.

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Testimony of Harrison LeFrak

The LeFrak Organization, New York

Before the Senate Committee on Finance

Hearing "Tax Reform: Examining the Taxation of Business Entities"

August 1, 2012

Introduction

Good morning, Chairman Baucus, Ranking Member Hatch, and members of the Committee. My name is Harrison LeFrak, and I am Vice Chairman of the LeFrak Organization. I appreciate the opportunity to discuss why maintaining the current taxation of pass-through entities is essential for the continued health and growth of real estate, oil and gas, entrepreneurship and investment in the United States.

Our Business

The LeFrak Organization is comprised of three business platforms: real estate development, energy exploration, and investments -- ground-floor investments in the companies of tomorrow as well as securities management and ownership.

Real estate: The LeFrak Organization was founded in 1901 and owns an extensive portfolio of real property concentrated in the New York, Los Angeles, South Florida, and London metropolitan areas.

The LeFrak Organization and its affiliated companies have developed and built a majority of their own portfolio. Since the late 1980's, affiliates of The LeFrak Organization have developed Newport, the largest new waterfront community in the United States. Newport has transformed an abandoned rail yard into what is now more than 1% of New Jersey's gross state product. We have recently begun new projects in Miami Beach and North Miami, Florida.

Energy Exploration: Affiliates of the company have originated and drilled a significant number of on-shore oil and gas wells in the continental United States. We have a very exciting shale oil project in Nebraska, which if successful, will be transformative to the

state. As a domestic explorer and producer, we are doing our small part for America's energy independence.

Investment Management: Affiliates of the LeFrak Organization have provided and continue to provide strategic capital to entrepreneurs and early state businesses in technology, financial services and health care. We have invested in numerous start-up companies that have created hundreds of new jobs. Locations of these companies include California, South Florida, Michigan, Texas and New York. In addition, the LeFrak Organization has been an investor in fixed and income securities, equity securities, currencies and commodities.

Why Partnerships Are Essential for the Success of Our Business[1]

Partnerships allow our business to establish discrete entities for each enterprise. Each project, building or oil field is in its own partnership. The ownership of each project or business reflects the objectives, risk tolerance and liquidity needs of various family members and investors. In addition, each partnership provides a discrete way to measure the success or failure of outcomes and to limit risk on a project-by-project basis.

Furthermore, our lenders demand separate partnerships for each activity they are financing. Lenders want a guarantee that the assets they are financing are protected and not subject to third party claims arising from unrelated business activities. Lenders demand that the assets are compartmentalized, especially in the event of bankruptcy.

Why We Do Not Use Corporations

We do not use corporations as investment vehicles to conduct our business because the cumulative rate of taxation on our enterprises would be confiscatory. The following example illustrates why the use of corporations would be inefficient:

[1] Pass-through entities are crucial to the success of the American economy. These businesses employ 54 percent of the private sector work force and pay 44 percent of federal business income taxes. Further, more than 20 million workers are employed by pass-through businesses with more than 100 employees. In 2008, 90 percent of all businesses were pass-throughs.

Comparison of Corporate versus Partnership Tax Rates (Top Brackets)

Tax Type	*Partnership*	*Individual Partner*	*Corporation*	*Dividend to Individual Shareholder*
Federal Income Tax Rate		35% (2012) 39.6% (2013)	35% (2012)	
Federal Personal Income Tax - Qualified Dividend Tax Rate				15% (2012) 43.4% (2013)
New York State Income Tax Rate		8.82%	7.1%	8.82%
New York City Income Tax Rate		3.876%	8.85%	3.876%
New York City Unincorporated Business Tax Rate	4%			

In 2012, our business is conducted in partnership form and our combined effective tax rate is **51.188%** (this calculation does not take into account AMT and PEP/Pease). That means that more than half of our income is devoted to taxes.

In 2012, if our business were conducted in corporate form and all profits were paid as a dividend to enable capital to be reinvested, our combined effective tax rate would be **64.53%** (this calculation does not take into account AMT and PEP/Pease).

In 2013, if our business is conducted in corporate form, all profits are paid as a dividend to enable capital to be reinvested, and Congress does not extend the 2001/2003 tax cuts, our combined effective tax rate would be **78.45%** (this calculation does not take into account AMT and PEP/Pease).

We as a family enterprise reinvest more than 95 percent of our business income back into our business activities and this tax proposal would be particularly onerous. We also rely entirely on our on capital to fund our business activities and do not receive one dollar of carried interest income.

Consequences of Imposing Corporate Tax on Partnerships

If this proposal becomes law, my family will stop building, stop drilling, and stop taking any risks.

As you can see based on the comparison of partnership and corporate tax rates, we would have paid 64.53% of our business income as tax if our business were taxed as a corporation. And that means we would have to work roughly seven and a half months a year to pay our taxes. In 2013, we would have to work nine and a half months to pay our taxes.

Add on top of that a 55% estate tax, and there is little incentive for entrepreneurs like us to continue to work.

The LeFrak Organization employs directly and indirectly more than 3000 people, and many of them would lose their jobs. We are a blue collar jobs machine everywhere we invest. The only jobs this proposal would create are for tax lawyers and accountants, as this proposal would add incredible complexity and enormous effort to our annual tax compliance process.

A lot of the complexity would need to be addressed in transition. Are current entities grandfathered? If not, how would partnerships address the change in economics that were not part of the business when the investors came together or when lenders lent the money to finance the business or when business decisions were made?

How would this proposal work? Would the determination of the partnerships subject to corporate treatment be based on income, revenue or size of assets? Would it apply on an annual basis, where an entity may be subject to corporate tax one year but not subject to corporate tax the next? Is there a taxable event when the partnership shifts into corporate tax and vice versa? How would this proposal apply when a partnership is owned by another entity, such as where a REIT has an interest in a partnership? What will states do, including the ones that conform to the Internal Revenue Code and the ones that don't?

There are numerous other transition and structural issues that Congress would need to address. I urge you to avoid adding such complexity to an already overly complex tax code.

Since Ronald Reagan, the policy of Congress has been to eliminate the double taxation of business income. This proposal goes in the opposite direction from that policy.

More important than my family and other entrepreneurs is what this proposal would do to the United States. Many investors, including pension funds, State pension funds,

foundations, charitable funds and other tax-exempt entities, currently invest in American partnerships without paying an entity level of tax. An additional level of tax will substantially reduce their returns and force them to seek returns offshore in other financial centers, including London, where foreign law does not impose a level of tax at the partnership fund level. The entire investment management industry, important to my home city of New York, would find itself uncompetitive with most other countries in the world.

My own family would have incentives to invest offshore, because we could avoid double taxation on our investments and benefit from foreign tax credits. Why would someone want to pay an entity level of tax in the United States when jurisdictions like Australia, Canada and the United Kingdom do not have an entity level of tax on such income?

Conclusion

Any imposition of new taxes on pass-through entity will have disastrous results not only on my family's enterprises but also on many American jobs. I strongly urge Congress and the Administration to abandon the proposal in the President's Framework for Business Tax Reform.

This concludes my testimony and I would be happy to answer any questions you might have.

Statement of

Dana L. Trier
New York, New York*

Before the
U.S. Senate Committee on Finance

Tax Reform: Examining the Taxation of Business Entities,
August 1, 2012

Chairman Baucus, Ranking Member Hatch, Members of the Committee. Thank you for inviting me to testify on this important topic. I would also like to thank you and your staffs for the time and effort devoted in recent months to considering substantial business tax reform and the myriad issues raised by such potential reform.

I bring to this testimony the perspective of four different types of experience. First is that of a lawyer who specialized in business taxation over a period of more than thirty years. During the first roughly ten years of that period, I focused on tax planning for closely held enterprises, both small and large and both commercial enterprises and services businesses; during the last twenty years or so I had a very diversified Wall Street practice representing investment banks, private equity firms, hedge funds, publicly traded partnerships and large corporations on both complex derivatives and other financial transactions and corporate and partnership matters. Second, I also look at things from the point of view of a part-time tax academic with a strong interest in the related disciplines of public finance and financial economics. Over the last three decades I have taught, and I continue to teach courses on corporate and partnership taxation, international taxation and business planning at Georgetown University Law Center, Columbia University Law School, the University of Miami Law School, and other institutions, which focus in large part on the issues we discuss here. Third, I served in the Office of Tax Policy of the Treasury Department in the administrations of Ronald Reagan and George H. W. Bush in a period during which a number of the issues we are considering here first began to emerge. Finally, I personally have been an investor in both small and large enterprises

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* Adjunct Professor, University of Miami Law School Tax Program; Lecturer in Law, Columbia University Law School.

(albeit on a modest scale) and have found that my own inclinations as an investor affect my views on important tax issues.

Unfortunately, I must report that, despite this very varied experience and extensive study of the tax policy literature over a long period, I find most of the issues we will discuss in this hearing to be quite difficult ones. It is clear to me that we inevitably will be required to consider various subtle tradeoffs.

In my testimony I will focus on business entity taxation in five different settings. First, of course, is that of the publicly traded U.S. corporation, the type of business entity that tends to receive the most attention in the tax academic and public finance literature. The second is the closely-held business engaged in small or medium size businesses, both businesses like those of my grandfather and father in the Midwest manufacturing goods or equipment or distributing products, and businesses like today's emerging high technology enterprises in fields ranging from information technology to energy and biotechnology. The third context is that of the personal services business, such as management consulting, healthcare and my own former business of law. Fourth, I will discuss the publicly traded partnership. Finally, I will address various hybrid entity configurations in which multiple types of entities are employed to conduct a business enterprise, a type of structure that is extraordinarily common today.

My testimony will be divided into three parts: First, I will provide a summary historical overview of where we were at the beginning of the 1980s, and what happened importantly with respect to the taxation of business entities over the next three decades; second, I will provide a general tax policy perspective on the taxation of business entities, as a predicate to a more detailed discussion; in the final part of my testimony, I will discuss a number of contemporary issues pertaining to the taxation of business entities.

I. Historical Perspective: Where Were We; What Happened; Where Are We Now?

A. The Tax Setting in 1980.

Because, as we shall see, some of the historic policy concerns relating to our two-tier corporate tax system could re-emerge in the future, it may be useful to recall the tax setting when I first began to practice (and teach) tax law in the late 1970s and early 1980s before the "Reagan Revolution" and the Tax Reform Act of 1986 and its aftermath. First, as to large publicly held corporations, the so-called "classical" system of corporate taxation was in full force and effect: there was no real relief from double taxation; and even then financial products, like the seminal ARCNs product of the early 1980s, were being concocted on Wall Street that were intended to exploit the more favorable tax treatment of debt than equity in the C corporation context.

Second, in those days, business planning for the closely-held corporation engaged principally in businesses like manufacturing, product distribution, transportation or high technology was a very tax-intensive enterprise. The highest individual tax rate greatly exceeded the corporate tax rate, which meant that, in many contexts, taxation under Subchapter C was preferable to taxation on a flow-through basis. The planning involved could be quite aggressive, as taxpayers attempted to evade application of the penalty taxes like the accumulated earnings tax; and compensation planning and estate planning were both very much an integral part of the tax planning process for these entities. At the same time for some businesses who wished to distribute earnings currently a Subchapter S election had to be considered and might make sense.

Third, tax planning for services entities such as law firms and medical practices was also a tax-intensive affair. Because those were the days before so-called "parity," incorporation of a services entity was to a significant extent driven by the greater tax advantage associated with qualified retirement plans maintained by corporation. Moreover, because of the lower tax rate on the first $100,000 of corporate income, there was an incentive to "undercompensate" the service provider (the lawyer or doctor) by, for example, deflecting the law firm income to a professional corporation, which in turn paid salary compensation to the service provider (the lawyer) of $50 to $100,000 less than the income allocated by the firm. The late Martin Ginsburg and I, who taught the tax component of the business planning courses offered at Georgetown in those days, both practiced law through personal service corporations, which were in turn partners in law firms; tax planning for the "partnership including professional corporations" was my introduction to mixed-entity configurations, which are so commonplace today and which I will discuss later in this testimony.

B. What Happened in the Next Three Decades

An enormous amount changed during the next thirty years. Indeed, quite a bit changed just from 1981 to 1986, and as a result I ultimately had to throw out every one of more than 500 draft pages I had written for a never to be published book on "Tax Planning for the Closely-Held Corporation."

1. Tax Rate Changes

To begin with, early in the Reagan Administration, the maximum tax rate applicable to the nonservices income of individuals was dramatically decreased, which, of course, had an enormous effect on tax planning, particularly for closely held businesses. Moreover, in fits and starts, with some variations in the tradeoff over time, the corporate rate and the maximum individual rate have converged over these three decades significantly to the point that even if the Obama administration and the Democrats get their way in the current debate over the

extension of the Bush tax cuts, there will still be what I view as rough parity between the two rates.

2. Parity in Employees Benefits Taxation

In addition, very substantial parity has been achieved with respect to the taxation of tax-favored employee benefits between incorporated and unincorporated entities. Although the general problem of "overcompensation" of the service-provider present in the partnership including professional corporation remains, particularly in the context of S corporations, new rules were enacted that largely eliminated the type of income splitting that Marty Ginsburg and I were engaged in which exploited the lower rates on the first $100,000 of corporate income.

3. Repeal of General Utilities Doctrine

A third major development, as the more senior Members of the Committee will recall, was the repeal of the General Utilities doctrine in 1986. This repeal was directed at assuring that the gain inherent in corporate assets held by a C corporation would be fully subject to tax at the corporate level at least once; and this change did increase tax neutrality in certain respects in the context of taxable corporate acquisitions. However, General Utilities repeal also introduced its own nonneutrality as to tax regime choice. In part for this reason, the publicly traded partnership phenomenon began to gain force shortly after the 1986 Act, and a large number of S corporation elections were made.

4. Changes to the Classification Rules and the Rise of the LLC

Another major change occurred over the period from the late 1980s to the early 1990s, the development of new entity classification rules, which have had a huge effect on tax planning for business entities. Actual state law corporations still must be taxed under Subchapter C unless an S corporation election can be and is made. But limited liability of business owners can now, it appears, largely be achieved without regard to tax factors. An investor can form a limited liability company (LLC) to conduct a business enterprise, and the enterprise will generally be taxed on a pass-through (one tax) basis as a partnership (or a disregarded entity if there is only one owner); alternatively, the taxpayer can check the box and have the entity treated as a C corporation. For new entities, the role of the S corporation election has diminished significantly, although it remains of some interest to those who wish to engage in "under-compensation" of the service provider. Today, while entities taxed as C corporations are still very much part of the landscape for emerging enterprises, partnership taxation is generally a much more important subject than is corporate taxation in teaching courses like the business planning course at Georgetown I co-taught last Spring. And the newest

law textbook on business planning for venture capital has a whole chapter devoted to LLCs.

5. The Rise of Multiple Entity Configurations

Moreover, partly because of the flexibility of the check-the-box rules, tax planning with respect to business now often entails the use of multiple types of entities, including entities taxed in the two-tax world like C corporations and flow-through entities like LLCs that are treated as partnerships for tax purposes, and including both U.S. and foreign entities. In our Georgetown business planning class last Spring, we simply had to discuss "Up C" structures and "Blockers." When my co-professor and I taught the same course together thirty years ago, those concepts were not even on the table.

6. Limited Corporate Integration

Finally, most recently, as a result of changes curing the administration of George W. Bush, we now have some relief for taxation of dividends. This relief, however, is of course slated to expire.

C. Where Does That Leave Us?

To some extent I describe this history to remind us that, for all our problems, there actually have been some positive developments in the taxation of business entities, at least from the perspective of my policy orientation. The overall rate on business income may be too high to satisfy our most ambitious goals, but the core rate structure applicable to many mainstream business enterprises is a lot less distortive than it was when I started my career; there really is quite a bit of neutrality in entity and regime choice today for ordinary business enterprises.

But significant challenges remain, which is in part why you are having this and other hearings. The highly competitive, interconnected world in which we find ourselves makes it more difficult to continue to have high corporate rates and be a bit sloppy about our corporate tax system, particularly with respect to its treatment of foreign income. Moreover, developments in financial engineering and sophisticated tax planning, developments in the world that I have inhabited for the last two decades, pose very significant issues, as we shall discuss further. The rise of private equity and other alternative investment vehicles such as hedge funds has, in particular, posed new and important issues, because it is to a large extent through private equity funds and hedge funds that U.S. tax-exempts and foreign taxpayers invest in our businesses. My own perspective is that we simply cannot fail to address those issues systematically and comprehensively at this point, whether or not we ultimately make major statutory changes.

II. General Policy Perspective

Before I begin discussing a number of specific topics, I would like to provide an overall policy perspective on business entity taxation, because my experience has been that most of our disagreements on specific issues emerge from differences in basic perspective.

A. Neutrality

In a perfect world, taxation of the business income would distort business activity as little as possible. Consistent with this perspective, I personally continue to believe, despite some fashionable academic commentary to the contrary, that the maximum rate applicable to both business and other income should be as low as possible consistent with raising necessary governmental revenues and a reasonable but relatively constrained level of progressivity as to tax rates.

This general world view has three central implications for the taxation of business entities. One is that in a perfect world the overall tax burden should not depend significantly on the business entity through which it is conducted, whether that be a state law corporation, limited liability company, partnership or other entity. Second, it would be optimum if there were not a substantial disparity between debt and equity financing of business activities conducted through an entity taxed as a corporation. Third, to the extent possible, the decision whether or not an entity distributes net profits of the business to the owner or owners of the equity of the entity should not depend materially on the tax burden on those distributions.

B. The Function of Entity Level Taxation; Relevance of Public Trading; Progressivity

I should emphasize at this point that my own policy perspective is that the function of taxation at the entity level is principally an administrative one, a question of collecting tax on business income. We cannot, of course, fail to tax U.S. business income generated by a corporate or other business entity currently. And at least in the context of a publicly traded corporation such as IBM or Microsoft, it would be difficult to collect tax efficiently at the shareholder level. It is an important question of design whether payment of the tax by the business entity (e.g. a corporation) is essentially as a withholding agent (in which case shareholder attributes may ultimately determine the applicable rates), or as the principal taxpayer (in which case the rate of taxation and other matters is determined at the entity level). But the ultimate goal is to impose only one level of tax on business income.

Thus, for example, the relevance of public trading reflected in the so-called PTP rules of section 7704, is not, in my view, a substantive one. As a

matter of first principles, I do not believe the overall burden of taxation of business income should be increased as a surcharge for the liquidity benefits provided by public trading. In the perfect world, where we tax the income of publicly traded entities, including partnerships, should be based on practical concerns.

This one-level-of tax orientation does affect my views on some subtle issues. For example, so long as we do collect the tax on business income once, I am somewhat less fussed than some with respect to a limited measure of non-neutrality between different types of entities (flow-through or corporate) that conduct the same kind of business (for example, businesses engaged broadly speaking in the financial services arena).

This overall conception of the role of entity taxation may also have implications for one's approach to progressivity concerns. Taxing business income, for example, at a very high overall rate is, in my view, an extremely clumsy mechanism for addressing inequality; indeed, it may even ultimately harm progressivity. At the same time, it would be optimal if we could design an appropriate system for business income taxation that would not undo or distort the overall level of tax progressivity that we, as a polity, ultimately settle on. In this regard, a significant number of issues are potentially raised with regard to various forms of integration and business entity taxation and with respect to other related issues, such as capital gains policy.

C. Taxing All U.S. Business Income at Least Once

The other side of the coin of not overburdening the taxation of U.S. business income with multiple layers of taxation is assuring that all such income be, in fact, taxed at least fully once. I put my own emphasis on that task. Here my principal concern is with leakage of U.S. business income to the tax-exempt sector or foreign taxpayers; more broadly, I myself believe that we will have to reconsider the precise boundaries between the taxable and tax-exempt sectors. Virtually every important tax issue that I have spent time considering in recent years (carried interest, debt-equity, derivatives) ultimately is affected by the central role of such parties. The issues relating to the taxation of business entities are no exception. A comprehensive treatment of this topic is beyond the scope of this testimony; but as will become clear, even here, the issues cannot be completely avoided.

D. Why It Is So Difficult To Design An Efficient System Of Business Taxation

A major constraint that we face in designing a system of business entity taxation going forward that satisfies my admittedly very ambitious objectives is, of course, revenue. During these economically sluggish times in which we are not collecting sufficient tax revenues in the first place, it certainly will be difficult to implement ambitious full-scale corporate integration schemes without some significant offsetting revenue-enhancing feature. Later in this testimony, I will discuss a few other specific policy issues in which there may be design tradeoffs, affected in part by revenue considerations.

In addition, several other factors complicate greatly formulation of an appropriate policy approach to the taxation of business entities. One major one for me is uncertainty as to the economic incidence of business taxation.[1] Despite the development of a relatively voluminous literature since Harberger's original seminal work on the incidence of corporate taxation, there is really no firm consensus on this question, and it may very well vary from sector to sector. One public finance economist has remarked that it is difficult to discuss entity taxation intelligently when in fact there is no such thing. As Governor Romney (admittedly a bit clumsily) recently reminded us, taxation at the corporate level is ultimately a tax on people, whether investors, consumers or labor. There are also significant "tax incidence" issues at stake in the carried interest controversy, for example.

A second major problem is that an optimum design for the treatment of corporate entities ultimately depends on the proper taxation of capital. Payment or accrual of interest on "debt" instruments of a corporation is, of course, deductible, whereas a corporation receives no deductions for the cost of equity capital. This distinction creates significant distortions and inefficiency. A number of the corporate integration schemes, including those addressed by Professor Warren in his written testimony, are efforts to cope directly with the pervasive problem of the debt-equity distinction. I might also note here that I believe there are broader tax arbitrage issues that are associated with the taxation of corporate finance (and executive compensation) in the public corporation context that may merit further scrutiny. Because there have been recent hearings on debt-equity and financial products, however, I will not discuss those issues here.

Third, the interrelationships between the capital gains preference and the appropriate taxation of both corporations taxed under Subchapter C and partnerships and LLCs taxed under Subchapter K raise important issues. One basic question, for example, is the tax rate that should be applicable to the sale of

corporate stock of a C corporation, an issue that implicates both corporate integration issues[1] and capital gains concerns like lock-in. In addition, as discussed in a report issued by the Treasury Department late in the administration of George W. Bush, strong arguments can be made for some capital gain preference at the corporate level.[2]

Fourth, the differing contexts of closely-held corporations and publicly-held corporations raise very difficult questions both of policy and administrability. I have recently been struck, for example, by how much the economics literature concentrates on the taxation of dividends in the publicly-held corporation context. As we will discuss later, dividend taxation in the closely held corporate context may pose a different set of concerns. Similarly, the policy concerns with respect to the taxation of executive compensation, for example, may be completely different in the closely-held and publicly held contexts.

Finally, I think we all understand that the extreme instability of our political system with respect to tax and budgetary issues has ultimately become a significant detriment for both economic policy generally and tax policy in particular. I have been struck recently how students of tax policy now view attainment of a measure of stability as, independently, a significant issue of policy design. Whatever the merits of dividend taxation relief, for example, it certainly cannot make sense for it to be turned on and off again completely every few years, depending upon who is, temporarily, on top in the political wars.

III. Current Issues of Business Entity Taxation

A. Lowering the Maximum Corporate Tax Rate

The threshold question that we face today is whether the maximum corporate rate should be lowered significantly. The resolution of this issue will in turn affect the appropriate treatment of a number of other issues related to the taxation of business entities that we will discuss here.

Although a full discussion of the question is beyond the scope of this testimony, I will state here that I am squarely in the camp of those that believe a significant effort should be made to lower the rate applicable to corporate business income, while at the same time broadening the tax base applicable to such income. First, the intensely competitive international situation drives us to such an effort: while reforming the taxation of international income is probably the dominant consideration, lowering rates generally is also important. Second,

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[1] See Burman, **The Labyrinth of Capital Gains Tax Policy**, pp. 76-77 (1999).

[2] "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," Office of Tax Policy, U.S. Department of Treasury, pp. 72-75 (Dec. 20, 2007).

from the point of view of economic efficiency, we, in many ways, now have the worst of all worlds, relatively high marginal rates coupled with various distortive preferences that lead to a significantly lower average rates of collection. Third, a lower applicable rate might facilitate (somewhat) resolution of other difficult issues of tax reform, including for example the taxation of international income. Thus, while I am deeply skeptical that we can achieve, consistent with fiscal responsibility, the more ambitious goals that have been publicly announced (a rate of 25 percent for example), I think the effort to do the best we can on corporate rate reduction and base broadening is a worthwhile one.

From the time this issue started to be discussed, however, I have thought that the elephant in the room is the question what happens to maximum individual rates at the same time corporate rates are lowered. I am very skeptical, for example, that we can, in the context of our existing political machinery, achieve broad-based tax reform simultaneously permitting quite low maximum rates applicable to both entities taxed as C corporations and individuals, even though that would be my perfect world. Thus, in my view, we are likely to face a series of subtle tradeoffs, some of which I will discuss here.

B. The Tax Treatment of Closely-Held Business Entities

Assuming, for the moment, that it does become impossible, after business tax reform, to maintain our rough current rough parity between the top marginal rates applicable at the corporate and individual levels, a basic policy issue we will face is the tax treatment of closely-held businesses. Some of the relevant issues were comprehensively discussed recently by Professor Daniel Halperin of Harvard Law School,[3] and I will highlight a few here. To anticipate the discussion that follows, I will say at the outset that I am ultimately not comfortable with permitting a very large disparity between the maximum individual and corporate tax rates to re-emerge.

1. Planning For Closely-Held Enterprises Today

To begin our discussion, let us first review the situation today. At this point, a simple way to look at the situation is that the principal gating issue in entity and tax regime choice with respect to closely held businesses relates to who are going to be the principal owners of the equity of the enterprise. Closely-held enterprises like my grandfather's or father's in the Midwest that were owned principally by U.S. taxable individuals are likely, today, to be conducted through an LLC taxed on a flow-through basis. An alternative paradigm often applies to the emerging enterprise in the information technology space or the biotechnology

[3] Halperin, "Reducing the Potential Inequity of Reducing Corporate Rates," Tax Notes, p. 641 (February 1, 2010) (Halperin).

arena, for example, that fully expects to attract investment by institutional venture capital or private equity partnerships comprised in large part of U.S. or foreign tax-exempt investors. Even today, a corporation taxable under subchapter C or an LLC that checks the box to be treated as a corporation for tax purposes may be formed in that setting because of the concerns of institutional investors with respect to trade or business income or unrelated debt financed income (as well as other tax concerns). The additional tax burden relative to pass-through treatment is not, however, that significant today because of the relative parity of the maximum individual and corporate rates, the relatively low tax rate on dividend distributions and the low capital gains rules applicable to sales of corporate stock. Moreover, although there is some advantage to the tax partnership (LLC) form in dealing with founder equity interests received for services, that issue can usually be dealt with relatively easily in the subchapter C context as well, with some messiness, but ultimately without great tax "friction."

2. Tax Planning for the Closely Held Business if the Rate Differential Becomes Significant

If the rate differential became very substantial again – let us say for illustration 40 percent maximum individual rate and 28 percent maximum corporate rate, tax planning for the closely held business would change substantially, reverting in many ways back to a setting like that I faced early in my career in tax planning for closely held businesses and that I briefly summarized earlier in this testimony. Use of the business vehicle as, in part, an "incorporated pocketbook" would again become part of the tax planning scene, as wealthy closely-held business owners might want to hold more of their portfolio assets at the corporate level and benefit from lower rates at that level. I would undoubtedly start teaching the accumulated earnings tax and personal holding provisions again after a 25 year hiatus. Genuine concerns of tax progressivity would be raised. Admittedly, we could, as suggested by Professor Halperin, buttress the government's arsenal a bit to deter the use of the corporation from being used as a tax shelter for investment and services income; in this regard the step-up-in basis at death would become a particularly significant issue to address. At the end of the day, however, I believe a tax rate differential that significant would be a tax lawyer's dream rather than particularly good for the economy.

It may be worth considering at this point two different conceptions of the function of business income taxation. Consider first the situation I confront today in my own investments in small enterprises. Assume that I, together with a number of other taxable U.S. investors, have invested in LLCI, LLCII and LLCIII and that the income from each of those separate business enterprises is taxed at a roughly 40 percent marginal rate on a flow through basis because we have not checked the box. In this situation, although I might quarrel a bit with the marginal rate (I certainly would prefer it to be lower), there is a significant amount of tax-economic neutrality. If, for example, excess earnings are generated

by the business conducted by LLCI, the entity (a partnership for tax purposes) can distribute those earnings to me without an additional layer of taxation; and if I am inclined to do so, for entirely economic reasons, I can invest part or all of those distributed earnings in LLCII or LLCIII or a new enterprise without a significant tax friction. On the margin, taxation of business entities is not significantly interfering with economic activity.

Under a competing conception of the role of business entity taxation, a "split-rate" structure could be adopted applicable to closely-held and other business enterprises. Thus, for example, the overall tax social contract could be that the rate of taxation applicable to business income of a closely held interest could be 28 percent rather than 40 percent, but only so long as the original capital and later generated net earnings remain committed to the business enterprise. To the extent that withdrawals from the business enterprise are made, a significant level of tax would be imposed (perhaps even 40 percent or higher). At these rate levels, the split rate structure would start to approach the structure in place more than three decades ago.

The tradeoffs associated with such a structure were very much in evidence in the 1970's and very early 1980's, when I first began to practice tax law. Indeed, in my teaching at that time, the operation of that split-rate structure was the principal focus. The tax "social contract" was enforced, clumsily and inefficiently, by the high marginal tax rate applicable to corporate dividends and penalty taxes such as the accumulated earnings tax.

I personally much prefer the basic situation in place today with relative parity of maximum rates and, for now at least, significant dividend tax relief if the business enterprise is conducted in an entity taxed as a corporation. The key is that I can move my investments (and the fruits of such investments) relatively efficiently among different enterprises with different co-owners. In some ways, I view this issue as analogous to the issues we face in the international tax arena; I am in general uncomfortable with high tax rates being applied at the margin to the redeployment of capital (by, for example, repatriation of earnings).

Taking all this into account, where I come out on the relevant tradeoffs, is that we should make every effort to maintain a rate differential of no more than 6 to 7 percent between the maximum corporate rates and maximum individual rates. Implicit in that judgment is the view that some of the revenue gained by general base broadening should be committed to keeping the maximum individual rate relatively low; and in my view, that means base broadening itself must be undertaken with an eye firmly focused on general progressivity concerns.

C. The Second Level of Taxation: Dividend Relief and Capital Gains Taxation on Stock Sales

Both of the issues we have discussed thus far ultimately affect analysis of the question of dividend relief, whether relief of the type reflected in the Bush tax cuts (in effect, a partial exemption at the shareholder level), or more systematic integration of the type discussed by Professor Warren both in his scholarly work and in his written testimony. Thus, it is difficult to discuss this policy question meaningfully without knowing what the maximum rate will be at each of the individual level and the corporate level and without separately taking into account the publicly traded and the closely-held contexts. The tax rate applicable to capital gains is, of course, also relevant although I tend to view that question here as part of the overall corporate tax policy inquiry.

As a thought experiment, let us first assume again that corporate tax rates are lowered substantially relative to the maximum individual rates. Some have suggested recently, including Len Burman in testimony before you, that it might be reasonable to consider discontinuing the provision of dividend tax relief at the individual level because the lower corporate rates will in part compensate for the overtaxation of corporate income and the revenue saved could be utilized more effectively elsewhere. At the same time, Professor Halperin has argued that a substantial tax rate on corporate dividends would be necessary to buttress progressivity and constrain exploitation of the advantageous corporate-level rates by wealthy individuals in the closely-held context if the maximum rate on corporate income were reduced significantly. The same points of view might be consistent with a relatively robust tax rate on gains from the sale of corporate stock, certainly solidly above the current 15 percent rate.

However, as noted above, I personally am ultimately not really comfortable with re-introducing a very substantial rate disparity in the first place. Thus, while I might feel a bit more flexible in the public corporation context eliminating this dividend relief, I am significantly less comfortable in the closely-held context.

Now let us consider an alternative future: assume that the tax reform efforts underway in Congress now fail and we end up with a rate structure for individuals and corporations roughly like that before the Bush tax cuts (except perhaps as to the treatment of middle-income taxpayers). In that setting, I guess I continue to have a bit more favorable view of retaining the dividend relief now in place than some tax academics might have (including perhaps Professor Warren). I would acknowledge that dividend taxation is truly a complicated subject under our current system.[4] There is a burgeoning literature in economics on the

[4] For a good overview, see Shaviro, Ch. 5.

uncertain behavioral effects of the dividend relief provided during the Bush administration.[5] There clearly remains a non-neutrality between dividends and share-buybacks because shareholder basis can, in part, be recovered with respect to the latter; and the dividend relief we have provided only ameliorates the distortive effect of the debt-equity distinction in, at best, a very modest way.

But for reasons I will not fully develop here, if the substantial reform effort fails, and no alternative integration mechanism is adopted, I would continue the experiment of partial dividend taxation relief into the future. In fact, I would extend the relief now pending further consideration of broader reform. In these regards, I am motivated in significant part by the treatment of closely-held enterprises that may very well continue to be conducted in entities taxed under Subchapter C. I also am somewhat influenced by what I perceive to be the possible behavioral responses of taxable investors like myself in the public markets if dividend relief is completely eliminated with respect to publicly traded stock in the context of a very low interest rate world with substantial uncertainty.

D. Treatment of Services Businesses

While raising not nearly as many intractable issues, the tax treatment of services entities has also become an issue in recent years.[6] This renewed interest was in part fueled by the news stories relating to the S corporations of Messrs. Edwards and Gingrich; it also has been prompted by the increased number of quite large services businesses, including law firms like those in which I practiced the last twenty or so years of my own career. My own perspective here is quite simple; services income should be taxed fully at the same rate as services income generally once and only once.

To begin with, let us consider what I have termed earlier in this testimony "undercompensation", and what one student of tax policy has recently called "labor stuffing." While under section 269A, for example, the Internal Revenue Service has been granted authority to address the planning arrangements that proliferated in the 1980s, I do believe a broader grant of statutory authority for combating this type of planning is perhaps merited that would buttress the government's efforts in the corporation context and, in the future, perhaps elsewhere. The result will be some disputes of fact and ultimately more tax litigation. But there is no reason the Internal Revenue Service should not have the clear authority to assert that all the income of an entity substantially generated by

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[5] A useful review of the earlier literature on the subject is contained in Darmapala, "The Impact of Taxes on Dividends and Corporate Financial Policy: Lessons From the 2000s," in Viard, **Tax Policy: Lessons From the 2000s**, 199 (2009).

[6] See Halperin at pp. 650-652 for a discussion of some of the most important of these issues.

services is taxed as services income as opposed to, for example, ordinary income of an S corporation.

More recently, a completely different issue has been raised, at least in some circles: should a portion of the income generated by a large services business such as a large law firm, in effect, potentially be subject to an incremental tax at the entity level? I really do not believe we should go there. I probably do think there is something akin to goodwill or growing concern value associated with my old firm Davis Polk, for example. If it were decided pass-through taxation regimes should no longer be available to larger businesses, one could argue that a large law firm should not be able to "zero-out" its net income with deductible compensation paid to the "partners." Thus, there would be some amount to be taxed at the entity level and potentially subject to tax again when distributed. But here again my own policy orientation determines my bottom line conclusion; one level of taxation is enough, and in this context the key policy emphasis should be to assure the earnings are treated fully as services income subject to the Medicare portion of self-employment taxes and the like when appropriate and, in fact, collected.

E. Publicly Traded Partnerships

The treatment of publicly traded partnerships (PTPs) presents, for me, a less straightforward series of issues, in significant part because of where Congress has already come on these issues. Here also, my strong one-tax orientation, my emphasis on administrative issues as to the location of tax collection and my concerns about achieving the proper boundaries with respect to the tax-exempt sector affect my overall views, which are ultimately not strongly-held ones in this particular context.

Today, under section 7704 publicly traded partnerships, as defined in the Code and Regulations, are subject to treatment essentially as C corporations unless certain exceptions are met, the most important of which are applicable when the partnership has certain type of "qualifying income." A significant number of PTPs are in existence that qualify for those exceptions. The taxation of PTPs generally was addressed in an excellent recent article by Eric Sloan and Matthew Lay.[7]

[7] Sloan and Lay, "Beyond the Master Limited Partnership: A Comprehensive Review of Publicly Traded Partnerships," 88 Taxes, No. 3, 229 (March 2010).

1. When Should Partnership Interests Be Treated As Publicly Traded

The first issue I would like to discuss briefly here is whether the current regime for determining whether a partnership is a publicly traded partnership in the first instance is workable and gets the question about right. Personnel at Treasury in the late 1980's and early 1990's (including myself) were responsible for developing the current regulations. The basic inquiry is to determine whether "taking into account all the facts and circumstances the partners are readily able to buy, sell or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market."[8] A number of safe-harbors and other detailed rules are provided intended to implement the basic concept. Those rules are exhaustively discussed in the article of Eric Sloan and Matthew Lay, and I will not go into them here. The rules do pose some tricky issues, and there have been significant developments in the financial marketplace since the rules were originally developed. However, having practiced in the area myself and re-considered the rules for panels and the like over the last few years, I am not particularly uncomfortable with the basic line drawing that has been done. In other words, I do not believe a significant policy concern is raised by how we have drawn the line as whether an entity should be treated as a publicly traded partnership in the first instance. It is important to note, in this regard, that I am coming to that conclusion in part because I believe these rules operate in a way that is consistent with administrative considerations for reporting and collecting tax; the line they draw coincides with a boundary that generally permits the complex rules of partnership taxation to be applied accurately.

2. The Reporting and Collection Mechanism for PTPs

Where I believe there is a question legitimately meriting further consideration is with respect to PTPs that exempt from the rules, for example because the entity has the requisite amount of so called qualifying income. The core issue is whether the entity can be expected to comply fully with the complex subchapter K rules in a context where the interests are publicly traded. The technical and practical issues are well-discussed by Messrs. Sloan and Lay who work extensively in the area. Based on my own experience as a lawyer for a few PTP clients and on a few major transactions involving PTPs, I believe taxpayers and their advisors have, on balance, been quite responsible in trying to make the system work, and I personally doubt any great harm to the fisc is being done currently. However, like Professor George Yin, I am not entirely comfortable

[8] Regulation Section 1.7704-1(c)(1).

with the situation.[9] In my perfect world, I would concede that the principal types of "qualifying income" are subject only to one level of tax (and benefit from preferences like the capital gain preference), but collect the tax at the entity level. In other words, I would not re-visit the basic judgment as to C corporation status, but I might at least consider a different administrative approach to tax reporting and collection.

While I have not carefully thought about the point, one possible difficulty with this entity-level approach to collection, as a practical matter, may be the treatment of tax-exempts. Under today's rules, as discussed by Messrs. Sloan and Lay, tax-exempts can generally invest in these entities subject generally only to application of the normal unrelated business and unrelated debt financed rules applicable to tax-exempts investing in partnerships; and leaving aside for the moment the so-called Advisor PTP Structure, I am not particularly bothered by that situation. As a result, however, if there were entity-level collection, it would be necessary to formulate some sort of refund mechanism for tax-exempts allocated income that otherwise, as to them, should bear no tax burden. I am not sure of the real scope of this practical problem because many PTPs may be unsuitable for investment by tax-exempts anyway.

3. The Advisor PTP: The Blackstone PTP and Its Progeny

That leaves the question whether what Sloan and Lay call the Advisor PTP structure should be viewed as covered by the PTP exceptions or whether, as originally proposed by Chairman Baucus and Senator Grassley (in proposed legislation that was not ultimately adopted), these partnerships should have not been excepted from the PTP rules. My guess is this policy question has in effect been decided by inaction, but I will discuss it briefly. Unlike Professor Yin[10] I do not view the Baucus-Grassley proposal as a "back-door" way to address the carried interest question. While I strongly oppose the proposed carried interest rules (at least in their current incarnation) for reasons that I will not go into here, I at the same time continue to believe the basic approach (assuming it was made administrable) of the Baucus-Grassley proposal was a reasonable exercise in line drawing as to what kind of income should be subject to the PTP rules; whether or not the capital gains income from the carry allocated through these entities can benefit from the preference, it is akin to financial services income, which generally has not been viewed by Congress as appropriately excepted from the

[9] Yin, "Publicly Traded Partnerships, Closely Held Corporations and Entity Classification for Tax Purposes," 88 Taxes, No. 3, 329 (March 2010) (Yin).

[10] Yin at 229.

PTP rules. Here again I may be somewhat affected in my views by the treatment of investors that are tax-exempts.

F. UP C and Similar Multiple Entity Structures

A central feature of the contemporary tax planning landscape for business entities is the use of structures in which entities with more than one type of tax treatment are used simultaneously in configurations ranging from the relatively simple to the quite complicated. In my view, many of those structures do not raise significant policy concerns, particularly when viewed from the perspective of my policy predilections. But that decision should be made by Congress advertently, not with ignorance of the actual facts on the ground.

One now quite commonplace such structure is the use of a one-tax flow-through entity such as an LLC treated as a partnership together with a publicly traded entity. This type of structure originated in the real estate area (so-called UPREITs, etc.), but is now more and more common in other settings. Those in the know often refer to one variation of such structure as an "Up C" structure.

Consider, for example, the closely held business historically conducted in partnership form (or more likely an LLC taxed as partnership) whose current owners (the founders) now want both access to the public capital markets for their business and, ultimately, to provide an exit into the markets for disposition of all or part of their own equity interests in the future. A C corporation is formed to sell stock equity to the public that in turn invests in the partnership with the founders (or a newly formed tax partnership to which the old partnership or LLC interests are contributed by the founders). At the same time the equity interests of the founders are made economically exchangeable, subject to limits, into the corporate stock of the public C corporation. The income of the tax partnership conducting the actual business remains subject to one-tax flow-through treatment to the extent allocable to the founders; to the extent allocable to the C corporation, the income is potentially subject to two levels of tax. The founders are also able to avoid the immediate tax transaction costs that might have been entailed if they had simply checked the box before the offering for their entity to be taxed as a C corporation and the old entity went public, or they contributed their equity interests to a new C corporation in connection with the offering by that C corporation.

Does this type of structure present a core tax policy problem? If you believed that the kind of potential exit to a liquid public market involved here should not be available without the business income of the structure potentially being subject in its entirety to a two-level tax regime, you might think so. From my own perspective, however, this particular type of relatively straight-forward multiple entity configuration is ultimately not, in the main, problematic. There is

nothing about this configuration itself that prevents assessment of one full level of tax on business income, which for me is the ultimate goal as I have emphasized.

G. Blockers and Stoppers

A more urgent area of policy concern in my view is the general proliferation of blockers and stoppers in business tax planning. Indeed, a blocker entity is generally involved in the Advisor PTP structure. In a recent article,[11] Willard Taylor, a distinguished member of the New York bar, recently defined these entities as follows:

> Generally, a blocker or stopper is an entity inserted in a structure to change the character of the underlying income or assets, or both, to address entity qualification issues, to change the method of reporting, or otherwise to get a result that would not be available without the use of more than one entity.

I believe a systematic policy assessment of these structures is long overdue. But I want to be careful as to what I am saying here: it is perfectly possible to me that, in many contexts, most of us could agree that the role of the blocker is an entirely benign one. Moreover, in some cases, as Mr. Taylor points out, if the blocker were not permitted, the taxpayer might be able to use a financial derivative instead to achieve its purposes. (Another reason these issues are such difficult ones.)

Three aspects of the current situation with respect to blockers concern me the most. First, some policy questions – such as the proper limits of the unrelated debt financed income rules – are in effect being answered through the use of foreign blockers. A long line of Treasury Department officials in the administrations of both parties (including myself) have tolerated the use of such offshore blockers because they believed that the underlying unrelated debt-financed income rules being avoided were overbroad. Given all the controversy generated over recent years, however, I think it is clear the basic substantive issue should be tackled head on.

Second, in some contexts, the use of a blocker puts significant pressure on the debt-equity distinction in our tax law. In hearings such as this one, we commonly focus on the economic efficiency costs of the debt-equity disparity with respect to corporate finance. But everyday, in a wide variety of contexts, this slippery and arbitrary distinction shows up with respect to the use of blockers

[11] Taylor, " 'Blockers', 'Stoppers' and the Entity Classification Rules," 64 Tax Lawyer 1 (Fall 2010).

in a way that potentially affects the basic business tax base substantially. In some contexts, the income subject to our business tax base is being determined virtually entirely by the operation of a blocker.

Third, I expect that some very subtle issues as to the appropriate boundary between the taxable world and the U.S. tax-exempt world are raised by the use of off-shore blockers in particular. Consider, for example, the use of a foreign corporate blocker through which both U.S. tax exempts and foreign taxpayers invest into the United States. The effect often will be view to treat the two different classes of investors (U.S. tax exempts and foreign taxpayers) the same for determining the U.S. business tax base and, generally, to treat the two types of taxpayers as foreign for this purpose. I am not certain (either way) that those are the correct policy results. Here too the boundary between the tax-exempt and taxable worlds ultimately must be addressed to rationalize entity taxation.

Statement of Alvin C. Warren
Professor of Law, Harvard Law School
at a Hearing of the Senate Finance Committee on
the Taxation of Business Entities
August 1, 2012

Mr. Chairman, Senator Hatch, and Members of the Committee --

Thank you for inviting me to testify today on this challenging and important subject.[1] I want to emphasize three points: (1) the longstanding U.S. taxation of corporate and investor income needs to be reformed to reduce economic distortions; (2) the boundary between taxable and pass-through entities needs to be rethought to reflect changes in the legal environment and in the capital markets; and (3) reform of the taxation of business entities is extraordinarily complex because it requires consideration of a large array of different combinations of domestic and foreign income, entities, and investors.

I. Relationship between Corporate and Investor Taxation[2]

The United States has long had a "classical" income tax system, under which income is taxed to corporations and to shareholders as distinct taxpayers.[3] Interest paid to suppliers of corporate debt capital is deductible by the corporation, but dividends paid to shareholders are not. Taxable income earned by a corporation and then distributed to individual shareholders as a dividend is thus taxed twice, once to the corporation, and again to the shareholder on receipt of the dividend. As a result, the current regime is often characterized as a "double tax" system.

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[1] I appear on my own behalf. This statement does not purport to represent the views of any institution with which I am affiliated.
[2] Some of the material in this section is taken from Michael Graetz & Alvin Warren, Integration of Corporate and Individual Income Taxes: An Introduction, 84 *Tax Notes* 1767 (September 27, 1999).
[3] Unless otherwise indicated, "corporation" in this statement means a corporation subject to federal income taxation, commonly called a "C corporation." See Internal Revenue Code of 1986, as amended (hereinafter IRC), §1361(a)(2).

The actual U.S. tax system is considerably more complex. For example, some income earned through corporate enterprise is taxed only once, at the corporate level. This is the result for corporate taxable income distributed as dividends to tax-exempt shareholders, such as pension funds and charitable endowments. Other income earned through corporate enterprise is taxed only once, at the investor level. This occurs when corporate earnings are distributed as deductible interest payments to taxable debtholders. Finally, some income earned through corporate enterprise is not taxed in the U.S. at either the corporate or investor level. This is the result for deductible interest paid to certain foreign and tax-exempt holders of U.S. corporate debt. Accordingly, domestic corporate income is sometimes taxed twice in the U.S., sometimes once, and sometimes not at all.

The current U.S. system of taxing corporate income distorts several economic and financial choices, of which the following structural distortions are sometimes said to be the most important:

1. Disincentive for investment in new corporate capital: U.S. investors are discouraged from investing in new corporate equity because of the additional burden of the corporate tax, distorting the allocation of capital between the corporate and non-corporate sectors.

2. Incentive for corporate financing by debt or retained earnings: U.S. corporations are encouraged to finance new projects by issuing debt or using retained earnings, rather than by issuing new stock, in order to avoid an additional level of tax.

3. Incentive to retain corporate earnings: The tax system can encourage retention of earnings by corporations to avoid the tax on dividends.

4. Incentive to distribute corporate earnings in tax-preferred forms: The tax system encourages U.S. corporations to distribute earnings in tax-preferred transactions, such as stock repurchases that give rise to capital gains, rather than by paying dividends.[4]

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[4] Under current law, dividends are generally taxed at the same rate as capital gains, but only the latter allow a basis offset. IRC §§ 1(h)(11), 301(c)(1) 302(a)-(d).

In fact, the extent and direction of these distortions depend crucially on the relationship of four tax rates: the rate on corporate income, the rate on individual investment income, the rate on dividend receipts, and the capital gains rate on the sale of corporate shares.[5] For example, if the corporate, dividend, and capital gains rates were sufficiently low relative to shareholder rates on ordinary investment income, the classical tax system could *encourage* investment in new corporate capital.[6] Similarly, if individual rates were significantly lower than corporate rates, the tax system could encourage *distribution*, rather than retention, of corporate earnings.[7] Although we cannot therefore specify the exact distortions of a classical corporate tax system without assuming particular rate relationships, we can say that the structure of such a system invariably leads to distortions of the type described here.[8]

In theory, there are a variety of ways in which the individual and corporate income taxes could be integrated to reduce these distortions. The corporate tax could, for example,

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[5] For further discussion of these relationships, see Alvin Warren, *Integration of the Individual and Corporate Income Taxes* 21-46 (American Law Institute, 1993), reprinted in Michael Graetz & Alvin Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* 617-635 (Tax Analysts, 1998).

[6] If the individual ordinary income tax rate were 40% and the dividend tax rate 10%, a taxpayer who invested $1000 in a noncorporate asset producing 10% annually subject to current taxation would have $1791 after 10 years: $1000 \times (1.06)^{10} = 1791$. If the same amount had been invested in a corporation earning the same rate of return and subject to an annual corporate tax of 10%, the corporation would have $2367 after ten years: $1000 \times (1.09)^{10}=2367$ A distribution of that amount would yield $2230 to the shareholder after paying dividend tax of $137 on the corporate earnings and profits of $1367. In this example, the tax system favors corporate investment over noncorporate investment.

[7] If the individual ordinary income and dividend tax rates were 10%, distribution of $1000 in retained corporate earnings would yield $900 to a shareholder after tax, which in turn would be worth $2130 after 10 years if invested at a 10% rate of return: $900 \times (1.09)^{10} = 2130$. If the corporation retained the $1000 and invested that amount at a 10% rate of return when the corporate tax rate was 30%, it would have $1967 after 10 years: $1000 \times (1.07)^{10} = 1967$. A distribution of that amount which would yield the shareholder $1770 after paying the dividend tax of $197. In this example, the tax system favors distribution of corporate earnings over retention.

[8] Particular rate relationships may eliminate certain distortions while leaving others in place. If in the example in the preceding note, the corporate and shareholder tax rates were the same, there would be no incentive to retain or distribute dividends, whatever the rate of dividend taxation. Assume a corporate and individual tax rate of 25% and a dividend tax of 10%. If the corporation distributed the $1000 in retained earnings, the shareholder would have $1855 after 10 years: $900 \times (1.075)^{10} = 1855$. If the corporation retained the earnings, it would have $2061 after 10 years: $1000 \times (1.075)^{10} = 2061$. A dividend in that amount would again yield the shareholder $1855 after paying the dividend tax of $206.

be repealed and shareholders taxed currently on corporate earnings, but that approach would require a complex annual allocation of undistributed corporate income to a myriad of capital interests. Alternatively, the corporate tax could be repealed and shareholders or corporations taxed annually on changes in share values, but that approach would require abandonment of the realization criterion of income taxation. For these reasons, the shareholder allocation and annual valuation approaches have not generally been pursued in the U.S. or abroad. Instead, attempts to integrate corporate and investor taxes have usually involved one of the following distribution-related approaches:

> **1. Shareholder credit for corporate taxes paid**: When a shareholder receives a taxable dividend, the shareholder would also receive a tax credit for corporate taxes previously paid with respect to the dividend amount, just as a wage earner now receives a credit for income taxes withheld by the employer. If fully implemented, this approach would convert the corporate tax into a withholding levy for income ultimately to be taxed at the shareholders' tax rates.
>
> **2. Corporate deduction for dividends paid**: Dividends, like interest, would be deductible when paid by the corporation. Under this approach, any previously paid corporate tax would in effect be refunded to the corporation when dividends are paid to shareholders. Essentially similar results could be obtained by imposing a lower corporate tax rate on distributed earnings than on retained earnings.
>
> **3. Shareholder exemption for dividends received:** Dividends would be exempt from taxation at the shareholder level, so that the corporate tax would be a final tax on income earned on corporate equity. This approach could also be applied to debt capital, so interest would be nondeductible to corporate borrowers and nontaxable to corporate debtholders.
>
> **4. Rate alignment:** Investor tax rates on dividends and capital gains on sales of corporate stock would be reduced as a partial offset to the additional tax at the entity level.

Each of these approaches has advantages and disadvantages. The shareholder credit was proposed in an American Law Institute study in 1993, on the grounds that it offers the fullest solution to the defects of current law.[9] This approach was once

[9] Warren, *supra* note 5.

widespread among our major trading partners, but has largely been abandoned in recent years in Europe, due to EU treaty restrictions that do not apply to the U.S.[10]

The dividend deduction produces the same general result as a shareholder credit (final taxation at the investor level), but without the compliance advantage of corporate withholding. Moreover, a dividend deduction without withholding would automatically and unilaterally reduce U.S. taxes on corporate income distributed as dividends to tax-exempt and foreign shareholders. If withholding on dividends were considered important to assure compliance, a deduction for dividends would be the equivalent of a shareholder credit, because the withholding credit could fulfill the same function as the shareholder credit.

In the 1992, the Treasury Department proposed a Comprehensive Business Income Tax (CBIT), under which corporate interest and dividend payments would be neither deductible nor taxable.[11] The corporate tax would therefore be a final tax on income earned through taxable entities. In 2003, the Treasury Department proposed legislation that would exempt dividends paid out of income that had been taxed at the corporate level.[12]

Both a shareholder credit and a dividend exemption would result income earned through corporations being taxed once, but only once. The principal difference is that the

---

[10] The Court of Justice of the European Union has interpreted the foundational treaties of the EU to prevent tax-system discrimination against income or investors from other member states. Since shareholder credits were generally not available for either foreign income or foreign investors, many member states feared that their credits would violate the nondiscrimination requirement. See Richard Vann, Trends in Company/Shareholder Taxation: Single or Double Taxation? -- General Report, 88A *Cahiers de droit fiscal international* 21, 66 (2003); Michael Graetz and Alvin Warren, Income Tax Discrimination and the Political and Economic Integration of Europe, 115 *Yale Law Journal* 1186, 1208-1212 (2006).
[11] U.S. Treasury Department, *Report on Integration of the Individual and Corporate Tax Systems -- Taxing Business Income Once* 39-60 (1992), reprinted in Michael Graetz & Alvin Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* 119-161 (Tax Analysts, 1998).
[12] U.S. Treasury Department, *General Explanation of the President's Fiscal Year 2004 Revenue Proposals* 11-22 (February 2003).

shareholder's tax rate would apply under the credit, whereas a standard rate would apply to all corporate income under the exemption.

Congress rejected the dividend exemption proposal in 2003, in part because of complexities intended to prevent exemption at the shareholder level for dividends paid out of income that had not been taxed at the entity level. Instead, the dividend tax rate was aligned with the maximum capital gains tax rate (generally 15 percent),[13] and the requirement that tax had been paid at the corporate level was dropped.

The trouble with this approach is that it is an incomplete and haphazard response to the distortions described above. To begin with, the lower rate on dividends does not depend on the income having been taxed at the entity level. Corporate debt is still generally favored over corporate equity. Corporate income is still sometimes taxed once, sometimes twice, and sometimes not at all. Finally, a substantial reduction of the corporate tax rate, as is currently under discussion, would reduce some of the distortions described above, but might exacerbate others, depending on the new alignment of corporate, individual, dividend and capital gains rates.[14]

The longstanding problems in the relationship of the corporate and investor taxation described above thus remain unresolved. My personal view continues to be that a shareholder credit for corporate taxes would be the best resolution because it would assure that capital income earned through corporate entities was taxed once and only once,[15] at the same graduated rates applied to capital income earned by the investor

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[13] Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27), §302.
[14] See, e.g., Daniel Halperin, Mitigating the Potential Inequity of Reducing Corporate Taxes, 126 *Tax Notes* 641 (February 1, 2010) (analyzing rate relationships necessary to prevent use of corporations by high-bracket individuals to shelter income from services or investments after a substantial reduction in the corporate tax rate).
[15] At least one well-know previous proponent of a dividend exemption has subsequently come to the view that capital income should be taxed primarily to investors, rather than exclusively to entities. See *Statement*

outside such entities.[16] Such a credit would eliminate the need for special tax rates for dividends and capital gains on the sale of corporate shares.

II. Relationship between Taxable and Pass-through Business Entities

The longstanding unsolved problems described in the preceding section have been exacerbated in recent years by two developments. The first is the dramatic rise in the use of pass-through entities to conduct business in the United States. The income of these entities, such as partnerships and subchapter S corporations, is not taxed at the entity level, but is included in the income of the entity's owners. In 1987, the number of pass-through entities surpassed the number of taxable corporations and has nearly tripled since then.[17] More importantly, business income earned through pass-throughs, which represented less than one quarter of net business income in 1980, had grown to more than 70 percent of such income by 2008.[18] Finally, pass-throughs are apparently much more important in the U.S. economy than in other OECD countries.[19]

The growth in the importance of pass-throughs has included the creation by the states of a new form of business entity, the limited liability company (LLC), which have proliferated since their inception 35 years ago.[20] LLCs are not corporations under state law, but generally provide limited liability to their owners. Under the "check the box"

of Michael J. Graetz, Professor of Law, Columbia Law School, at a Hearing of the Senate Finance Committee on Tax Reform 7 (March 8, 2011).

[16] Proposals to transform the corporate tax from a tax on income to a tax on consumption or valued added are beyond the scope of this statement. See, e.g., Alan Auerbach, *A Modern Corporate Tax* (Hamilton Project, 2010).

[17] Joint Committee on Taxation, *Selected Issues Relating to Choice of Business Entity* 1 (JCX-20-12), March 5, 2012.

[18] *The President's Framework for Business Tax Reform, A Joint Report by the White House and the Department of the Treasury* 7-8 (February 2012).

[19] U.S. Treasury Department, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* 16-17 (July 23, 2007).

[20] Joint Committee on Taxation, *supra* note 17, at 23.

regulations promulgated by the Treasury Department in 1996, domestic unincorporated entities with two or more members that are not publicly traded may generally elect to be treated as either a partnership or a corporation for federal income tax purposes.[21] LLCs generally choose to be taxed as partnerships, marrying limited liability with pass-through taxation. Publicly traded partnerships must in principle be taxed as corporations, but there is an important exception for entities that receive almost all of their income from certain kinds of investments.[22]

The second development that has compounded the difficulties of taxing business entities has been the growth of private equity. Over the past several decades, private equity funds, venture capital funds, hedge funds, and similar investment vehicles have attracted large amounts of capital investment from institutional investors such as pension funds and charitable endowments, as well as from wealthy individual investors.[23] These investment funds are generally structured as partnerships, sometimes organized in foreign jurisdictions.

Historically, business owners have chosen to incorporate in order to receive certain non-tax advantages, including limited liability and access to the public capital markets.[24] The tax result of such incorporation was usually the entity-level federal income tax. With the rise of LLCs, incorporation is no longer necessary to achieve limited liability. With the rise of private equity, incorporation is no longer necessary to have access to large pools of capital. Given the passive income exception from corporate tax classification for publicly

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[21] T.D. 8697, Treasury Regulations §301.7701-3.
[22] IRC § 7704(c).
[23] Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* at 2 (JCX-62-07), September 4, 2007.
[24] Joint Committee on Taxation, *supra* note 17, at 1.

traded partnerships, incorporation is not even necessary for some entities to tap the public capital markets.

Under current law, the boundary between pass-throughs and taxable corporations generally depends on public trading.[25] Given the developments described above, this boundary needs rethinking. Limited liability, number of owners, type of activity, and size of the business have all been suggested as alternatives.[26] Of those, the size of the business seems most appropriate to me, given the growth of large businesses conducted in pass-throughs in recent years.[27] Of course, this boundary has to be informed by the structure of the tax applicable to corporations. One of the advantages of a shareholder credit is that pressure on the distinction between corporations and pass-throughs would be substantially less, since all entity income would eventually be taxed at investor rates.

III. Relationships among Domestic and Foreign Income, Entities, and Investors

So far, I have argued that the longstanding challenges of structuring a system for taxing corporations and their investors have been exacerbated in recent years by growth of pass-through entities and the rise of private equity. I now want to argue that those challenges are made even more difficult by the continuing globalization of the economy. Not only do more American businesses have more foreign income, but more American investors are investing in foreign entities. Similarly, foreign entities and foreign individual investors are likely to continue their penetration into the U.S. economy.

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[25] The requirements for particular types of pass-through entities, such as regulated investment companies (RICs), real estate investment trusts (REITs), and real estate mortgage investment conduits (REMICs) are beyond the scope of this statement.
[26] See Joint Committee on Taxation, *supra* note 17, at 61-67.
[27] For similar views, see President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 126-131 (November 2005); *The President's Framework for Business Tax Reform, supra* note 18, at 10.

For analytical purposes, let us consider a world in which there are two categories of income (U.S. and foreign), four categories of entities (U.S. corporations, U.S pass-throughs, foreign corporations, and foreign pass-throughs), and three categories of equity investors (U.S. taxable individuals, U.S. exempt organizations, and foreign investors). In that world, any change in the U.S. tax law relevant to entities and their investors will impact 24 different cases, only two of which Congress can ignore in writing legislation (foreign investors in foreign corporations and in foreign pass-throughs):

	US Income				Foreign Income			
	US corporation	US pass-through	Foreign corporation	Foreign pass-through	US corporation	US pass-through	Foreign corporation	Foreign pass-through
US taxable investor	1	2	3	4	5	6	7	8
US exempt investor	9	10	11	12	13	14	15	16
Foreign investor	17	18	19	20	21	22	---	---

Consider, for example, a proposal to reduce U.S. corporate tax rates, to be paid for by increasing rates applicable to U.S. shareholders. On balance, that might be neutral (or even detrimental) for U.S. taxable investors in U.S. corporations (case 1), while it would unambiguously beneficial for U.S. exempt investors in such corporations (case 9), as well as for foreign investors in foreign corporations operating in the U.S. (case 19). Now consider a reduction in corporate taxation, to be paid for by curtailing accelerated depreciation. Depending on the details, the results could be neutral in cases 1 and 9, but those results would be unambiguously negative for taxable investors in pass-through entities that benefit from accelerated depreciation (case 2).

Alternatively, consider a proposal to provide a shareholder credit for corporate taxes paid on income distributed as dividends. Such a proposal would reduce the disparity in treatment of income earned through U.S. corporations and U.S. pass-throughs, bringing cases 1 and 2 into alignment. On the other hand, it is not clear that the proposal should apply in cases 9, 11, 17 and 19, if exempt and foreign investors are not paying a shareholder-level tax to the U.S. Treasury.

Finally, consider a proposal to tax large domestic pass-through entities as corporations. That would eliminate differences in treatment of large businesses between the following pairs of cases: 1 and 2, 9 and 10, 17 and 18.

The foregoing are but a few examples of the multitude of proposals for tax reform that will affect entity and investor taxation. The table above shows that reform of the taxation of business entities is extraordinarily complex, because every proposal for legislative change requires examination of a large array of different combinations of domestic and foreign income, entities, and investors. Depending on the proposal, some of the cases shown will be more important than others in terms of their effects on economic production, distributional fairness, and government revenues. The table does not, however, exhaust the possibilities, because in the interests of manageability, it is limited to equity investors. Doubling the categories of investors to include U.S. taxable debt-holders, U.S. exempt debt-holders, and foreign debt-holders would double the number of cases to be considered.

COMMUNICATIONS

American Capital, Ltd.
Two Bethesda Metro Center, 14th Floor
Bethesda, MD 20814

Testimony submitted by Aldrich Boss, Vice President of Tax, American Capital, Ltd.
Bethesda, Maryland
Before the Senate Committee on Finance
"Tax Reform: Examining the Taxation of Business Entities"
August 1, 2012

Mr. Chairman and Members of the Committee, my name is Aldrich Boss, and I am the Vice President-Tax of American Capital, Ltd. which is headquartered in Bethesda, Maryland. I appreciate the opportunity to submit this testimony as the Committee examines pass-through entities and how the current tax code can distort business decisions that can impair job creation and economic growth. I want to bring to the Committee's attention how one of the tax code's rules governing regulated investment companies is influencing the investment decisions made by Business Development Companies, which invest predominantly in small- and middle-market companies formed and based in the United States.

Our company is organized as a publicly traded Business Development Company, or BDC. The BDC structure was created by Congress in 1980 through amendments to the federal securities laws. Under the 1980 amendments, a company can elect to be treated as a BDC and become subject to the Investment Company Act, the securities laws that govern mutual funds. In return for adhering to provisions of the regulatory regime set forth in the Investment Company Act – including limitations on how leveraged the company can be, compensation structures, and a host of other limitations – a BDC may raise its capital in the public securities markets for the purpose of investing primarily in small- and middle-market companies formed and based in the United States.

Congress understood in 1980 that small- and middle-market companies had difficulty in raising capital in the public markets and believed that BDCs could help provide additional opportunities for these companies. What was true then is true today. In fact, today, 28 BDCs have an aggregate market capitalization of more than $18 billion and estimated investment assets of over $26 billion. This level of investment represents investments in companies that are unable to secure capital, both in the form of equity and debt capital, efficiently from traditional sources. The BDC industry, through its investments today, supports hundreds of thousands of jobs across the country.

Since going public in 1997, American Capital has invested over $30 billion in more than 500 small and middle market businesses.

The federal securities laws impose a number of restrictions on BDCs that do not apply to other regulated investment companies. First, under the federal securities laws, a BDC must invest at least 70% of its assets in private U.S. companies or publicly traded companies with market

capitalizations that do not exceed $250 million. Second, unlike traditional mutual funds, BDCs are required to make such investments through privately negotiated transactions, not by merely purchasing securities in the open market. Finally, the securities laws require a BDC to offer managerial assistance to its portfolio companies, meaning that, a BDC must be an active investor, not a passive one. The nature of these investments means that BDCs have investment portfolios that are not very liquid and whose market value can vacillate sharply from quarter-to-quarter.

In 1986, Congress amended section 851 the Internal Revenue Code to allow BDCs to qualify as regulated investment companies (RICs) for federal income tax purposes. In essence, the 1986 amendments extended to BDCs the same tax treatment provided to other business entities that are subject to the Investment Company Act. This tax treatment has become important to the shareholders of BDCs, the majority of whom are retail investors. A RIC must distribute on an annual basis at least 90% of its taxable income to its shareholders and must distribute at least 98% of its taxable income each year by December 31to avoid a 4% excise tax.

Why?

BDC's receive dividend and interest payments from their portfolio companies and then pass on such earnings to their investors. This means that the portfolio company itself pays taxes on its earnings and then upstreams a portion of its after-tax earnings to the BDC, which, in turn, pays out the earnings to its shareholders. Without the RIC treatment afforded under section 851, the BDC investor would be subject not to double taxation, but potentially to triple taxation – at the portfolio level at the BDC level and then at the personal level. The section 851 treatment merely allows a tax efficient way to allow individuals to make capital available to the small and middle-market companies.

Unfortunately, compliance with section 851 can force a BDC to distort the manner in which it invests in small- and middle-market companies and may even cause it to forgo an investment or follow-on investments altogether. This distortion arises as a result of the so-called diversification requirements in section 851 -- requirements that were not drafted with the intention of applying to actively managed and illiquid investments.

Under the asset diversification test set forth in section 851, at least 50% of the value of a RIC's assets must be invested in (i) cash, cash items (including receivables), government securities and securities of other RICs and/or (ii) other securities that, with respect to any one issuer, do not represent more than 5% of the value of the RIC's total assets (the so-called "5% test") and not more than 10% of the outstanding voting securities of the issuer. Another provision of section 851 limits the concentration of investments in any one industry category. The 10% voting test was part of the RIC provisions initially added to the Internal Revenue Code in 1942.

The asset diversification requirements generally do not pose significant business challenges for traditional regulated investment companies. While legislation has recently been enacted to provide alternative penalties for inadvertent or *de minimis* compliance failures with the diversification requirements, there is no indication that traditional investment companies have found the diversification requirements to be an obstacle for serving their investment objectives. BDCs, on the other hand, are required by the federal securities laws to invest predominantly in smaller U.S.

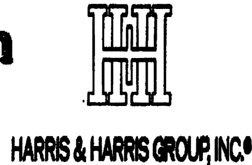
businesses, and, as a result, face greater difficulty in arranging their investments to comply with the 10% voting test. This is because a BDC often makes an economic investment in a small business (generally in the type of debt and equity securities where traditional bank financing is not available) that exceeds 10% of the value of the small business. In these circumstances, the 10% voting test forces the BDC and the small business to create a more complicated and less flexible capital structure for the small business, thus adding unnecessary and inefficient complexity to small business financings.

The 10% voting test makes it more difficult for a BDC to offer the type of financial assistance that best serves the interest of small- and middle-market companies and acts as an artificial obstacle to capital formation for such companies. For example, the 10% limitation encourages greater use of debt or debt like instruments in lieu of equity investments by BDCs and makes restructuring an existing BDC investment more difficult. Additionally, a number of BDCs make equity investments in small and middle-market companies through syndicates. Within those syndicates of investors, those with the greater voting power in the companies are the only investors, in many cases, that are permitted special rights, such as board of director seats, board observer rights and information and inspection rights. These rights are critical for BDCs in providing the required managerial assistance and also facilitating the information necessary to value the assets on a quarterly basis for financial reporting requirements. These rights are also beneficial to shareholders because they increase the BDCs ability to influence the growth and profitability of the portfolio company.

We would urge the Committee to consider either eliminating or significantly altering the 10% voting control limitation in section 851. I believe that the "5% value test" coupled with the limitations of investments in any single industry are sufficient restriction to prohibit a BDC from concentrating its investments in too few portfolio companies. If an additional voting control limitation is still considered necessary, I would urge the Committee to reduce the percentage of a BDC's investment portfolio that is subject to the voting rights test from 50% to 30%. This change would mirror the securities law requirement that 70% of the BDCs investment must be made in small- and middle-market companies.

I have attached to my testimony a letter from a group of BDCs requesting the Committee to consider modifying the 10% voting control rule.

We appreciate the opportunity to submit this testimony and urge the Committee to modify the tax code's RIC diversity rules to prevent further distortion of the investment decisions made by BDCs and increase the capital that BDCs can provide to small- and middle-market companies in the U.S.



November 11, 2011

The Honorable Max Baucus, Chairman
The Honorable Orrin Hatch, Ranking Member
Committee on Finance
United States Senate
Room 219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Baucus and Ranking Member Hatch:

As the Finance Committee examines options to spur economic growth we want to bring to your attention an industry that is focused on supplying capital to small and middle-market companies. In 1980 Congress amended the federal securities laws to establish Business Development Companies (BDCs). BDCs elect to be regulated much like other investment companies (such as mutual funds), but instead of buying and selling publicly traded securities, they are required to invest at least 70% of their capital in small and middle-market companies through privately negotiated transactions, and to offer active managerial assistance. Today, just as in 1980, these small and middle-market companies have very few alternative sources of capital. BDCs currently represent a market capital of nearly $18 billion.

In 1986 Congress amended the Internal Revenue Code to make BDCs eligible to be treated like other regulated investment companies. Because the RIC pass-through treatment requires the portfolio companies to have taxable income to upstream dividends, this treatment merely eliminated what would otherwise have been multiple level taxation on earnings (i.e., taxation at the portfolio company, BDC, and BDC shareholder levels).

The tax code's RIC diversity rules limit the percentage of assets in which RICs can have more than 10% voting control, as one test to ensure that the RIC's investments are sufficiently diverse. This diversity test artificially limits the amount of equity investments that can be made by a BDC in its portfolio companies based on quarterly mark-to-market valuations. Thus, this requirement artificially limits the ability of BDCs to make equity investments into new companies, or follow-on equity investments into existing portfolio companies. We do not believe this specific diversity test makes sense for BDCs who are required to invest in small and middle-market companies-- companies whose securities are either not publicly traded or are otherwise highly

illiquid. In addition, it does not make sense to have a tax code rule that limits the amount of equity investment a BDC could make in these companies or encourages them to assume greater debt when equity capital could have otherwise been made available.

We urge the Finance Committee to review how this diversity standard can either be eliminated or modified to better allow BDCs to serve the purpose Congress intended and to assist BDCs in serving the capital needs of domestic small and middle-market companies.

Sincerely,

AMERICAN CAPITAL, LTD.
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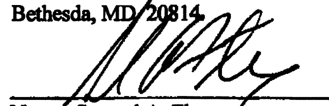

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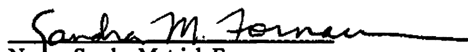

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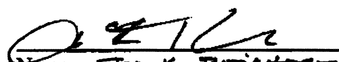

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SUBMISSION OF WRITTEN COMMENTS FOR THE HEARING RECORD
U.S. SENATE FINANCE COMMITTEE

HEARING TO EXAMINE THE VARIED TAX TREATMENT OF BUSINESS ENTITIES

AUGUST 1, 2012

Mr. Chairman, Ranking Member Hatch and distinguished Members of the Committee:

Carrix, Inc. ("Carrix") is pleased to submit written comments for the record in connection with the August 1, 2012 hearing of the Senate Finance Committee ("the Committee") on the critically important topic of the varied tax treatment of business entities.

Background on Carrix:

Carrix is a **closely held** U.S.-based port terminal operating company that manages more cargo terminals than any other company in the world. Carrix provides a full spectrum of transportation services, from terminal management to stevedoring, in a number of US and foreign ports.

As a closely held company built on international trade, Carrix fully appreciates the topic of the hearing: how the tax code has varied effects based on choice of entity, and additionally, imposes burdens on closely held corporations, which public companies do not face. Carrix, like many other US based companies in all sectors of the economy, faces fierce competitive pressure from foreign-based companies. Unlike most other US based companies, many of our foreign-based competitors are large foreign multinationals, some of which are closely aligned with foreign governments, and operate under more favorable home country tax regimes.

We would like to bring to the Committee's attention a tax issue that directly and negatively impacts our ability to grow our US operations: the potential application of the personal holding company (PHC) tax to earnings we would seek to repatriate in the form of dividends from our foreign subsidiaries. As will be discussed further, the PHC tax is an outmoded relic in the Tax Code that offers little, if any, compelling policy rationale for its continued existence. As the Committee considers the varied tax treatment of business entities, we believe the regime should either be repealed or substantially revised.

Background on the Personal Holding Company Tax

The PHC tax was enacted in 1934 and, at the time, represented an appropriate response to prevent individuals from sheltering investment income from individual income tax by using their closely held US corporations to hold investments, referred to as the incorporated checkbook. At the time the maximum individual income tax rate was substantially higher than the maximum corporate tax rate[1] and corporations could be liquidated on a tax-free basis.[2] Neither possibility exists today because of changes to the tax laws, yet the PHC provisions were never updated to reflect more modern circumstances, particularly closely held consolidated groups with foreign affiliates.

The PHC rules impose a corporate level penalty tax of 15% (the rate will become 39.6% in 2013 if the Bush tax cuts expire as scheduled at the end of 2012) on the undistributed PHC Income of a PHC. A corporation constitutes a PHC if 60% of its adjusted ordinary gross income is PHC income and if 50% of its stock is owned by five or fewer individual shareholders (including various attribution rules) at any time during the last half of the taxable year. PHC income generally is defined as interest, dividends, royalties, rents, and certain other types of passive investment income. The PHC penalty tax can be avoided by an entity by distributing PHC income to its shareholder(s), resulting in the shareholder(s) paying the appropriate tax on the distribution.

In the case of a group of US corporations filing a consolidated return, the PHC calculations are generally conducted on a consolidated basis. However, in certain circumstances the PHC test and tax computation must be made on a separate company basis. Section 542(b)(2) provides the PHC test must be applied on a separate company basis if more than 10 percent of any corporate member's adjusted ordinary gross income is received from a source outside the affiliated group (such as foreign subsidiaries) and more than 80 percent of such adjusted ordinary gross income is PHC income. PHC income would include dividends from foreign subsidiaries.

For each taxable year, if any separate corporate entity included in the affiliated group fails the test under Section 542(b)(2), the entire corporate structure is tainted and each separate corporate entity is potentially subject to the PHC tax. Thus, when the test is conducted on a separate company basis, a US group of corporations filing a consolidated return can easily find that it has a personal holding company tax liability even though a majority of its consolidated revenue may be active trade or business income and it would not otherwise be subject to the PHC tax except for the rules requiring separate company testing.

The policy rationales that led to the PHC tax regime are no longer operative. First, the top marginal tax rate for both individuals and corporations is 35%.[3] Second, with the repeal of the *General Utilities* doctrine in 1986, corporate liquidating distributions of

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[1] In 1934, the highest individual tax rate was 63% and the highest corporate tax rate was 13.5%, resulting in a 49.5% rate differential.

[2] *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935). The *General Utilities* doctrine was repealed by Congress in 1986.

[3] The top individual tax rate is slated under current law to rise to 39.6% on January 1, 2013 – resulting in less than a 5% differential between the top corporate and individual rates.

appreciated assets are taxed at the corporate level. ***Simply put: Today's tax laws do not provide an incentive to incorporate portfolio investments to escape the individual income tax.***

Application of PHC tax to Carrix

An example will help to clarify the lack of a compelling policy justification for the application of the PHC tax. The requirement to conduct the PHC tests on a separate company basis often unfairly penalizes corporate groups that are actively engaged in business. A common fact pattern that gives rise to this unwarranted imposition of the PHC tax is where a member of the group receives dividends from foreign subsidiaries. ***In this case, the PHC tax computation serves as a deterrent to the reinvestment of foreign earnings in the United States, further exacerbating the so-called 'lockout' effect.***

In other words, Carrix would be hit by the PHC tax to the extent it repatriated dividends from its overseas affiliates simply because it is a closely held company. If Carrix were organized as a public company, the PHC penalty tax would not apply. Simply because Carrix is closely held, the tax rate on foreign earnings repatriated back to the United States would be, rather than the normal 35% rate, a 50% tax rate. Such a level of tax makes it more economical for Carrix to keep foreign earnings offshore for purposes of further developing international operations, rather than using earnings from overseas operations to fund productive investments in the United States. In Carrix's case, for example, we would plan to use a portion of our foreign earnings to fund substantial upcoming capital expenditures.

Additional Policy Considerations

Carrix believes that additional policy considerations argue in favor of repealing, or substantially modifying, the PHC tax regime. The tax was enacted to prevent affluent individuals from escaping the reach of the individual income tax. Given the changes described above in our nation's tax laws, the PHC tax regime does less to deter the formation of so-called "incorporated pocketbooks" than to inhibit certain closely-held active businesses from pursuing logical business transactions that other companies are able to do because they may give rise to PHC tax consequences.

While some companies are able to evade the reach of the PHC tax through sophisticated tax counsel, other companies are not so lucky and are either unaware of the PHC tax or cannot avoid the tax unless they change their ownership structure. In addition, the PHC tax adds significant complexity to the Internal Revenue Code while raising a relatively nominal amount of tax revenue: approximately $38 million per year.[4]

Most importantly, from our perspective, the PHC tax unnecessarily and unfairly taxes revenues which would otherwise be available for investment in much needed

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[4] 2008 IRS SOI data.

infrastructure projects or other important corporate uses which would promote economic development in the United States.

Conclusion

Thank you for the opportunity to submit these written comments for the record. Carrix looks forward to working with you and your staff to ensure that the U.S. tax code is reformed in a way that makes sense, treats similarly situated taxpayers equally, and doesn't penalize certain closely-held taxpayers due to certain antiquated provisions of the Internal Revenue Code.

Comments for the Record

Senate Finance Committee

Tax Reform: Examining the Taxation of Business Entities

Wednesday, August 1, 2012, 10:30 AM

By Michael G. Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, VA 22304

Chairman Baucus and Ranking Member Hatch, thank you for the opportunity to submit these comments for the record to the Senate Finance Committee. As always, our comments are in the context of our four part tax reform plan:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure every American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

We refer Senators, staff and the public to our prior testimony before the committee for a more detailed presentation of these proposals, which are also available on our blog at http://fiscalequity.blogspot.com. We are also available for detailed briefings of our proposal.

Our proposals would regularize the taxation of business entities. Currently, how taxation occurs depends upon the form of ownership of the business. This will no longer be the case. Both the value added tax and the VAT-like net business receipts tax will be assessed on all value added, with the chief differences the two being that the VAT will be entirely border adjustable and have only one offset (excess NBRT offsets) while the NBRT will have offsets for various social purposes – from guaranteeing family income to providing health care and education for employees, future employees and retirees with no border adjustability unless a tax in excess of tax expenditures is actually collected (however tax benefits must first be fully utilized for this to be allowed.

Personal income taxes will only be filed for the highest quintile of taxpayers, with graduated rates so that middle class taxpayers pay less than those with the highest incomes. Much, if not all, of the complexity currently endemic to personal income taxation will be moved to business taxes, which will also be greatly simplified. The only possible personal income surtax deductions will be for sales of assets to a qualified Employee Stock Ownership Program and for charitable contributions – and even these may be forgone to achieve lower rates. The ESOP exclusion could ended if the NBRT includes an offset for creation of insured personal retirement accounts holding employer voting stock, as a tax incentive will no longer be required in such a case to bring about more such ownership.

The vast majority of taxpayers will no longer be required to file personal income taxes, provided that employer provided disclosures of Child Tax Credit benefits match those reported to the Internal Revenue Service, which will also provide a report of deductions paid. Filing will only be required if there is a difference between the two filings or if excess credits were granted by the employers of both spouses. This filing will require no more effort for employers than the current tax system, while greatly reducing the amount of effort required to process tax returns. Larger employers will likely be able to file all forms automatically and electronically as many firms do now.

Consideration was given to abandoning personal income taxation entirely, as proposed as a possibility by Lawrence B. Lindsey. We considered and abandoned this approach in our 2005 submission to the Presidents Task Force on Tax Reform because it would have some lower income taxpayers pay either too little or too much or require onerous privacy intrusions into the income and investment information of employees and investors in order to calculate the correct NBRT surtax amount. We concluded that the government would be preferable for this purpose than requiring sharing all employment information with brokers and invested firms while sharing all investment information with employers.

Many deductions and tax benefits required for business taxation will be abandoned because of the transition from taxing profit to taxing all value added, which includes both labor and profit. The rationale for many tax breaks simply do not exist when the base is broadened in this away – especially those targeted to specific industries. The biggest exclusion to be repealed will, of course, be labor costs – which is by far the biggest element of value added. While there will certainly be some complexity involved in judging the taxability of fixed assets, this will certainly be no more complex than the current tax code – with the possibility that many investments will be deducted in the current period.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

Statement
of the National Association of Manufacturers

For the Hearing Record
of the
Committee on Finance
U.S. Senate

Hearing on
"Tax Reform: Examining the Taxation of Business Entities"

August 1, 2012

Overview

The NAM is the largest industrial trade association in the United States, representing over 11,000 small, medium and large manufacturers in all 50 states. We are the leading voice in Washington, D.C., for the manufacturing economy, which provides millions of high wage jobs in the U.S. and generates more than $1.6 trillion in GDP. In addition, nearly two-thirds of our members are small businesses, which serve as the engine for job growth. NAM members commend Chairman Baucus and Ranking Member Hatch and the Committee for holding a hearing on tax reform and the taxation of business entities.

Manufacturers have long believed that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. To reverse these effects, the NAM supports lower tax rates on business income (including dividends and capital gains), a robust capital cost recovery system and a permanent and strengthened R&D incentive. We further support the adoption of a territorial tax system since current U.S. tax laws make it difficult for U.S. companies with worldwide operations to thrive and compete in the global marketplace. If U.S. companies cannot compete abroad, where 95 percent of the world's consumers are located, the U.S. economy suffers from the loss of both foreign markets and domestic jobs that support foreign operations.

The NAM supports current efforts to make the tax code more pro-growth, pro-competitive, fairer, simpler and predictable. Because of the critical importance of manufacturing to our nation's economy, any effort to rewrite the tax laws should result in a fiscally responsible plan that allows manufacturers in the United States to prosper, grow and create jobs.

Tax Reform Principles

In anticipation of the current tax reform effort, NAM members developed a set of principles for comprehensive tax reform that incorporate Manufacturers' tax reform goals and also serve as a framework for evaluating proposals and developments as the tax reform debate moves forward. The following principles, which were approved by NAM's Board of Directors in March 2012, touch on several areas including business tax rates, international competitiveness and research and technology investment. More generally, the principles focus on several issues that need to be addressed to ensure a simpler, fairer, more predictable and more balanced code.

Encouraging Investment and Job Creation

NAM members believe that any tax reform plan should encourage capital investment and job creation. To this end, a comprehensive tax reform plan should include:

- **Lower Corporate Tax Rates:** Reducing the corporate tax rate to 25 percent or lower would make the United States' tax system more competitive with our major trading partners. Any accompanying base broadening should recognize the impact of those changes on economic growth. Some current tax provisions, including capital cost recovery rules, are key to a strong manufacturing sector and broader economic growth and the benefits of these provisions should be maintained in a new system.

- **Lower Taxes for Flow-Through Businesses:** Two-thirds of manufacturers are organized as "flow-through" entities and pay taxes at individual rates. For these entities, it is critical that the tax rates on individuals be as low as possible. A new system should not increase the tax burden on these businesses to pay for other tax reform measures.

- **Permanent R&D Incentive:** It is critical that any tax reform plan recognize the important role of research and technology investment in the growth of U.S. jobs and innovation. The goal is for the United States to retain and attract global R&D activities. The certainty provided by a strengthened, permanent R&D provision would enhance its incentive value.

- **Taxation of Investment:** Keeping the tax rate on dividends and capital gains as low as possible and applying the same rate to all investment income will help public companies attract investors and allow them to finance investment and create jobs. An effective way to spur business investment and make the tax system more competitive is through a robust capital cost recovery.

Promoting International Competitiveness

Current U.S. tax laws make it difficult for U.S. companies with worldwide operations to thrive and compete in the global marketplace. If U.S. companies cannot compete abroad, where 95 percent of the world's consumers are located, the U.S. economy suffers from the loss of both foreign markets and domestic jobs that support foreign operations. In order to make U.S. multinationals more competitive, in addition to lower corporate tax rates and a permanent R&D incentive, the NAM supports the adoption of a competitive territorial tax system that meetings the following criteria:

- **Elimination of the double tax burden:** A U.S. territorial system should be based on the principle that there should be no double tax burden imposed by the United States. At a minimum, a new system should exempt active foreign earnings from taxation and avoid the imposition of a stealth tax on foreign earnings through expense allocations.

- **Alignment with international norms:** A U.S. territorial system should be structured to enhance U.S. competitiveness, not raise revenue. Moving to a territorial system like those used by other industrialized countries will allow U.S.-based companies to be more competitive.

- **A smooth and effective transition:** A move to a territorial tax system should include fair transition rules that allow repatriation of foreign-earnings on a voluntary basis, minimize administrative and compliance costs on companies and allow existing foreign business entities to compete with foreign-headquartered companies.

Ensuring a Simpler, Fairer and Balanced System

A new tax system should be simpler and more administrable and should treat all businesses fairly without regard to size, type of entity or sector. Specifically, a comprehensive tax reform plan should meet the following criteria:

- **No Net Increase in Manufacturers' Tax Burden:** Any alternative that shifts more of the current tax burden on to manufacturers will hamper economic growth and job creation.

- **Elimination of the Alternative Minimum Tax:** A new system should eliminate both the individual and corporate alternative minimum tax rules, which are inherently complex and unfair.

- **Administerability:** A new system should incorporate rules that make it easier for Treasury to administer the law and for taxpayers to comply with the law. Unnecessary complexity is not productive from an economic perspective and undermines taxpayers' confidence in the fairness of the law.

- **Predictability:** A tax code that is predictable and that provides certainty is essential for effective business and tax planning. A fair and stable tax code will make it easier for U.S. manufacturers to complete in the global marketplace.

- **Transition Rules:** A new system must include broad transition rules that provide fair and equitable treatment for taxpayers that have generated substantial attributes based on current law. For example, it is important for transition rules to allow future timely utilization of tax attributes, e.g., net operating losses, alternative minimum tax credits, foreign tax credits, depreciation etc., that have been generated but not yet utilized under the current system.

Lower Taxes for Flow-through Businesses

A central element to the discussion about remaking the tax code into one that will ensure the competitiveness of U.S. companies is ensuring that that any tax reform plan does not disadvantage flow-through businesses. As noted above, nearly two-thirds of manufacturers are organized as subchapter S corporations (S corps) or other flow-through entities and pay taxes at the individual rates. These companies play a critical role in our nation's manufacturing capacity. Any tax reform plan must be comprehensive and any changes, or base-broadening that occurs to reduce tax rates must adjust for the special impacts on these flow-through businesses.

For more than 60 years, business owners have chosen to organize as S corps or other flow-through entities to benefit from comprehensive liability protection and a single level of federal taxation. According to IRS data, between 1980 and 2008 the total number of flow-through

businesses more than tripled to nearly 31 million. In 2008, an estimated 54 percent of the entire private sector workforce was employed by a flow-through business. As a result, when considering tax reform, Congress should pay special attention to the impacts of any tax reform proposals on this type of business entity.

Since nearly two-thirds of manufacturers are organized as S Corps or other flow-through entities, it is critical that any tax reform plan include permanent lower individual marginal rates for these business owners. Moreover, according to 2008 IRS data, the average net taxable income for these small and medium sized manufacturers is $384,000 so maintaining competitive tax rates at higher income levels is critically important to these companies.

In addition, it is important for Congress to consider the unique impacts that specific types of base broadening would have on these smaller manufacturers and to address these impacts to ensure that tax reform does not increase the tax burden on these companies to pay for other tax reform measures.

Conclusion

As outlined in NAM's "A Manufacturing Renaissance: Four Goals for Economic Growth,[1] " a key objective for the Association is to create a national tax climate that enhances the global competitiveness of U.S. manufacturers. Manufacturers very much appreciate the efforts of Chairman Baucus and Ranking Member Hatch and the members of the Senate Committee on Finance for their diligent work to reform the U.S. tax system to put U.S. manufacturers on a level playing field with their competitors in other countries, as well as making the United States a more competitive environment in which to do business. We appreciate the opportunity to share our thoughts and concerns with you. Manufacturers look forward to further discussing these issues and working with the Committee to achieve a pro-growth, pro-competitiveness and pro-manufacturing tax system.

[1] Available at http://www.nam.org/

**WRITTEN STATEMENT OF THE
NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS
SUBMITTED FOR THE
SENATE COMMITTEE ON FINANCE HEARING ON
TAX REFORM: EXAMINING THE TAXATION OF BUSINESS ENTITIES
August 1, 2012**

The National Association of Publicly Traded Partnerships (NAPTP) is pleased to provide its views on the taxation of business entities and the treatment of pass-through entities. NAPTP is a trade association representing publicly traded partnerships, more commonly known as master limited partnerships (MLPs),[1] and other companies that provide services to MLPs or otherwise have an interest in their welfare. We currently have 122 full and associate members and represent 75 MLPs.

NAPTP strongly recommends that Congress continue to preserve the ability of business enterprises to choose the structure that is the most efficient and effective for their particular business activities, whether it be a pass-through structure or a C-corporation, in any future tax legislation. In particular, we ask that publicly traded entities that are currently able to choose pass-through taxation be allowed to continue doing so. To do otherwise, in our view, would not be good policy and would slow our nation's progress towards energy independence by reducing the capital available for needed energy infrastructure. It would also cost jobs in an economy that cannot afford to lose them, and would deprive a growing number of individual investors, many of whom are seniors, of a dependable source of income.

Background

MLPs have been in existence since 1981, and were first created to add liquidity to partnership investments. In doing so, they provided businesses that had traditionally operated in partnership form with the ability to raise capital from individual investors who could not afford the sizeable, illiquid, investment demanded by nontraded partnerships. By creating partnership investments that came in affordable units (the term for an ownership interest in an MLP) which were liquid, MLPs allowed smaller investors to invest in energy and real estate development while providing those industries with a valuable new source of capital.

In 1987 Congress enacted section 7704 of the Internal Revenue Code to limit MLPs to the industries that had traditionally used partnerships. Section 7704 limits pass-through tax treatment to publicly traded partnerships receiving at least 90 percent of their gross income from a narrow range of business activities, primarily those related to natural resources, or passive income sources such as interest and dividends.[2] Natural resources for this purpose include oil

[1] There are several dozen PTPs which are merely commodity pools and not entities conducting business operations. These are generally not thought of as MLPs.

[2] Section 7704 also permits real estate operations including the development, sale, and rental of real estate.

and natural gas (and products thereof), coal and other minerals, fertilizer, and timber, while permissible activities include exploration, development and production; mining; gathering and processing; natural gas compression; transportation by pipeline, ship, or truck; storage; refining; marketing; and distribution. Other than propane sales, permissible activities stop short of the retail level, so that revenue from operating gas stations, for example, would not be qualifying income. In 2008 Congress expanded section 7704 to also permit MLPs to engage in the transportation and storage of biofuels and to include industrial source carbon dioxide in the definition of natural resource.

When section 7704 was being considered by Congress, the continued use of the MLP structure by natural resources industries was supported by the Treasury Department, which had otherwise supported imposing corporate taxation on publicly traded business entities. In 1987 testimony before subcommittees of both the House Ways and Means and the Senate Finance Committees, Assistant Secretary for Tax Policy J. Roger Mentz stated that "consideration should be given to continued authorization of pass-through entities providing direct investment opportunities traditionally conducted in non-corporate form" -- and, more specifically, "Given the importance of natural resource development to the nation's security, Congress should consider carefully whether such traditionally non-corporate activities should be subjected to corporate level tax."

MLPs Today

Today MLPs are primarily engaged in natural resource activities. Natural resource MLPs comprise about 80 percent of MLPs by number, and about 90 percent of MLP market capital. The great majority operate in the midstream sector, which is focused on logistics and includes activities such as gathering and processing; natural gas compression; transportation by pipeline, ship, or truck; storage; and distribution services. Over 70 percent of MLP market capital, and over 80 percent of the market capital of natural resource MLPs, is in the midstream sector.

Midstream MLPs own approximately 300,000 miles of natural gas, NGL, refined product, and crude oil pipelines, a vast network ranging from local gathering lines that bring products from the field to processing plants to major interstate pipelines traversing thousands of miles. These pipelines are the backbone of our domestic energy system, serving as the link between energy producers and end-use consumers.

In addition to the MLPs that build and operate energy infrastructure, a number of MLPs provide consumers throughout the United States with propane for home heating and other uses. Some natural resource MLPs earn revenue from oil, gas, and coal properties. Some manufacture fertilizer, and others own timber properties either as a primary business or in addition to other natural resource activities. MLPs operate in every state, producing, processing, transporting, storing, and distributing energy products to meet the needs of that state's residents.

On August 1, 2012, the total market capital of MLPs was about $340 billion, of which about $300 billion was in the natural resource sector. MLPs raised over $9 billion in equity

capital during the first seven months of 2012.[3] As noted, a large part of this equity capital is devoted to expanding the nation's domestic energy infrastructure.

According to surveys done by some of our members, the majority of the investors providing this capital—up to 80 percent--are individual investors. Many of the investors are seniors--roughly 75 percent are over the age of 50. For the most part, they are individuals seeking a relatively secure income-oriented investment providing a reasonable return, something that is hard to come by in today's market. These investments are particularly attractive to fixed income investors because MLPs are contractually required to distribute all of their operating cash flow each quarter, providing investors with a reliable income stream. In addition to the individuals investing directly in MLPs, there are millions more who are investing in MLPs through one of approximately 45 MLP-oriented closed- and open-end mutual funds and ETFs. These funds provide individual investors with a comparable income stream without the tax complications of being a partner that direct investment entails.

In addition to providing income for investors, MLPs create jobs. As entities that distribute their cash flow rather than retain earnings, MLPs depend upon access to capital. Nevertheless, during the recent economic downturn, when capital was relatively scarce, they were among the first to recover, raising and investing billions of dollars in job-creating infrastructure projects at a time when most corporations were downsizing and laying off employees. A recent study performed for NAPTP by Quantria Strategies LLC found that midstream energy MLPs support approximately 323,000 U.S. jobs as of 2012, both directly and through supply chain linkage.[4] To the extent that growth in every sector of the economy depends on the free flow of energy supplies, MLPs may have an even greater impact on domestic employment.

Why MLPs Are Important

The majority of the growth in MLPs has been in midstream energy services because in the years since 1987, the energy industry has discovered that the MLP structure is uniquely well-suited for midstream operations. Midstream businesses require considerable capital for the construction of pipelines, processing plants, and other assets, and thus the cost of capital is a very important consideration for them. Once these assets are in place, they last a long time and generate a steady and reliable stream of revenue. This is a fee-for-service industry, generally not exposed to commodity price shifts but rather generating moderate revenue through contracts to process and transport natural gas, oil, and petroleum products.

While steady and reliable, the income from midstream assets is somewhat low in relation to the amount of capital expended, particularly in the case of rate-regulated pipelines. For this reason, corporate energy companies have increasingly preferred to divest themselves of these low-return assets and put their capital into more profitable exploration and drilling operations;

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[3] Wells Fargo Securities, LLC, *MLP Monthly: August 2012.*

[4] John F. O'Hare and Judy Xanthopolous, *Midstream Energy Master Limited Partnerships Economic Analysis – Contributions to Employment and Income*, June 2012.

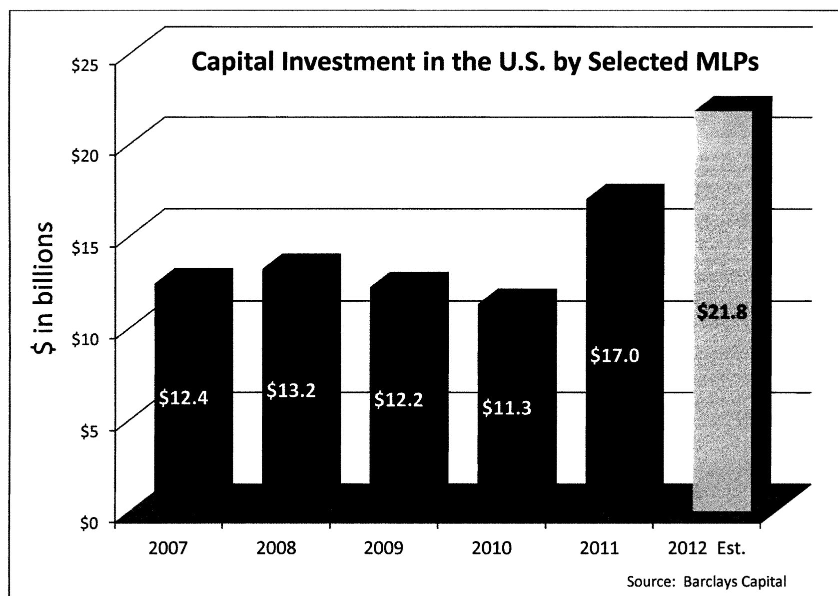
and when they do, these assets are typically acquired by MLPs. The single-taxed MLP structure lowers the cost of capital, allowing a more reasonable return on investment in these assets.

Moreover, the steady income stream allows midstream MLPs to meet a key demand of MLP investors: reliable cash distributions. As with any pass-through entity, MLP unitholders must pay tax on their share of the MLP's income every year, whether they receive it or not. Thus, an MLP will attract investors only if it pays out enough cash to cover the unitholder's tax and provide a reasonable return on top of that. Accordingly, MLPs' organizational documents contain a requirement that MLPs distribute their available cash flow to investors rather than retain earnings, and MLPs that fail to meet that standard do not do well in the market.

MLPs do not just own and acquire existing midstream assets; they are busily constructing new ones. Today it is increasingly MLPs that are building, expanding, and operating pipelines and other energy infrastructure in the United States. It is MLPs that ensure that domestic oil and gas get from the places they are produced to the places where they are consumed, in the forms which consumers need. Most importantly, it is MLPs that will advance the potential for energy independence by allowing natural gas and oil produced from the recently discovered shale plays to be fully utilized. Some of these shale plays are in areas with little of the infrastructure required to process and transport the underlying resources; others have overwhelmed the infrastructure that does exist.

A paper published by the INGAA Foundation in 2011 estimated that over the next ten years, we will need to invest $130 billion in natural gas, NGL, and oil pipelines and related infrastructure.[5] Over 25 years (2011-2035), $251 billion will be needed. Those investments are being made to a large extent by MLPs. Since 2007, the largest MLPs have made non-acquisition capital investments of approximately $66 billion, many of them in the shale-play areas. This year they are expected to invest another $21.8 billion, bringing total investment to approximately $88 billion.

[5] ICF International, North American Midstream Infrastructure Through 2035 – a Secure Energy Future, June 28, 2011.



According to the Quantria Strategies study, over the next five years the midstream MLP industry will support more than 1.6 million jobs on an annual equivalent basis,[6] or about 330,000 jobs per year, and will pay cumulative wages totaling $147 billion.

Consequences of Corporate Taxation

While MLPs are formed for a number of reasons, it is the pass-through tax treatment that makes the MLP structure such an effective vehicle for midstream assets. Pass-through taxation lowers the cost of capital for a capital-intensive industry with a very modest rate of return and provides ordinary investors with a reliable income source in return for participating in the build-out of U.S. energy infrastructure.

For these reasons eliminating the pass-through tax treatment of MLPs would significantly and adversely impact future investment in our nation's domestic energy infrastructure at a time when such investment is urgently needed. If such a change were made, there would initially be significant disruptions in the financing and construction of pipelines and related facilities during the transition, as MLPs coped with the new rules, and investors dealt with this significant

[6] Annual equivalent employment is defined by Quantria Strategies as the number of full-time jobs supported over a 12-month period.

change. After that, the build out would not be halted, but it would proceed more slowly and at a lower level than it would have if the law had not been changed,

A study by Phillip Swagel, former Assistant Treasury Secretary for Economic Policy, and Robert Carroll, former Deputy Assistant Treasury Secretary for Tax Analysis, found that the higher cost of capital resulting from corporate taxation of MLPs would reduce pipeline investment by close to 30 percent--or more--immediately following the change to corporate tax status, with investment still 13 percent to 20 percent lower ten years after the change. As a result of such a delay in building the infrastructure needed to deliver energy to consumers, U.S. businesses and households would face over $13 billion in higher annual energy costs, and possibly considerably more if reduced investment in energy transportation infrastructure led to serious bottlenecks that impacted energy prices.[7] It is likely that higher energy costs would in turn have a negative impact on the overall economy.

There would be a cost in jobs and wages as well. The Quantria Strategies analysis found that if midstream energy MLPs were subject to corporate-level tax, total annual employment would decrease by more than 27,000 jobs over the next five years and wages paid to workers directly and indirectly by the sector would decrease by about $2 billion.

Finally, imposing corporate taxation on MLPs would impact millions of individual investors, particularly seniors, who have turned to MLPs as one of the few remaining investments that reliably generate income in a low interest rate environment. The change would affect the value of over 100 MLPs, adversely impacting their direct investors, as well as the investors in dozens of open- and closed-end mutual funds, ETFs, and other investment vehicles whose assets consist wholly or largely of MLPs. Billions of dollars of assets would be devalued with one stroke of the pen. This is in marked contrast to 1987, when only about 35 MLPs with “nonqualifying income” were impacted by the new law, and MLPs were still a relatively obscure investment, with no MLP-oriented investment funds in existence.

Conclusion

Twenty-five years ago, Congress examined the question of whether MLPs should continue to be taxed as partnerships or whether all MLPs should have to pay corporate tax. It decided that while MLPs were not appropriate for industries that had historically used corporate structures, the energy industry, which was and is vital to our country’s well-being and which had always raised capital through partnerships, should continue to be allowed to expand its access to investor capital through the use of MLPs.

In the years since, that decision has proven to be a wise one. MLPs have operated as Congress envisioned in 1987 and are now an integral part of the way our nation is positioned to move forward in achieving greater energy independence by developing our own domestic energy supplies. Over the past several years, MLPs have raised tens of billions of dollars of capital, and have invested it in building new and vitally needed energy infrastructure, while at the same

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[7] Phillip Swagel and Robert Carroll, *The Impact of Changes to the Tax Treatment of Master Limited Partnerships*, January 2012.

time seeing that energy products make their way efficiently and in numerous forms from the production fields, through processing facilities, and across the country to end users.

MLPs have also grown to be an important investment option for many individuals, in particular older Americans looking for a safe and reliable income source to fund their retirement. Millions of individual investors are enjoying an investment opportunity that before the advent of MLPs was available only to the very affluent, while at the same time contributing to the achievement of energy independence.

As the saying goes, "If it ain't broke, don't fix it." There is no compelling reason as a matter of tax or other policy to subject MLPs to an entity-level tax. Neither public trading nor a particular size requires corporate taxation. As is often noted, the vast majority of entities paying corporate tax are both small and nontraded, and as was noted by witnesses at this hearing, entities both large and small now raise capital in a variety of ways.

Any concern over MLPs eroding the corporate tax base was ended in 1987 by the enactment of section 7704. The substantial growth in pass-through entities in recent years, noted by so many, did not come from MLPs. Imposing corporate tax on MLPs would do a great deal of harm to our efforts at achieving energy independence, to tens of thousands of workers, and to millions of investors, in return for a benefit that, if it exists at all, is very difficult to perceive.

SUBMITTED TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

Thomas J. Nichols, J.D., CPA[1]

August 1, 2012

Chairman Baucus, Ranking Member Hatch and Members of the Committee, this testimony reflects views that I have developed over more than three decades as a tax professional working with closely-held business entities, as well as my role as an advisor to the S Corporation Association.

A. Overview

The bipartisan Tax Reform Act of 1986 ("TRA '86") was a landmark piece of tax legislation. It allowed many closely-held business owners to migrate into a more rational single tax pass-through system, and in the process reduced their incentive to engage in expensive and sophisticated strategies in order to mitigate the onerous effects of the C corporation double tax rules. The system engendered by the TRA '86 has worked well for businesses and the country in the intervening years, and retaining these benefits will be critical to the success of any future tax reform efforts. In this regard, I respectfully submit the following general considerations regarding tax reform:

First, as much as possible, the business tax system in the United States should move toward a single tax structure, and away from the punitive double tax C corporation system. Especially for closely-held businesses, a single tax system substantially reduces complexity and eliminates the opportunity and incentive for non-productive tax planning and strategizing. Moreover, it has the benefits of simplicity and transparency.

Second, broadening the tax base and lowering and flattening the tax rates would serve all segments of society. Closely-held and other business owners respond to incentives. The lower the rate on a given amount of marginal income, the more likely it is that a business owner is going to expend the effort and take the risks in order to earn that income, and the less effort he or she will expend trying to defer or otherwise mitigate the tax consequences of having done so. Business owners will aggressively grow their businesses only if they have confidence that they can make money over the upcoming years and not be subject to punitive tax rates. They intuitively know that the country cannot generate enough revenue to solve all of its problems (much less those of the rest of the world) merely by taxing "the rich." However, they are afraid that they may be the first casualties in an ill-fated attempt to do so. This fear is depressing economic activity now.

Third, it is important that whatever tax reform is implemented be comprehensive. Focusing merely on the top C corporation marginal rate, and broadening the tax base for all business taxpayers in order to pay for it, unavoidably increases the tax burden for closely-held business owners, because, as I will explain, the large majority of closely-held businesses are operated through single tax pass-through entities and not as C corporations. Since pass-through business owners employ over half of the workforce in the country, lowering the tax rate for all taxpayers (rather than just the headline rate for C corporations) should be the goal of comprehensive tax reform.

B. Historical Perspective

When I first started practicing law in 1979, the top individual income tax rate was 70 percent,[2] whereas the top income tax rate for corporations taxed at the entity level ("C corporations") was only 46 percent.[3] This rate differential obviously provided a tremendous incentive for successful business owners to have as much of their income as possible taxed, at least initially, at the C corporation tax rates, rather than at the individual tax rates, which were more than 50 percent higher.

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[1] President and Shareholder, Meissner Tierney Fisher & Nichols S.C.

[2] I.R.C. § 1 (1979).

[3] I.R.C. § 11 (1979).

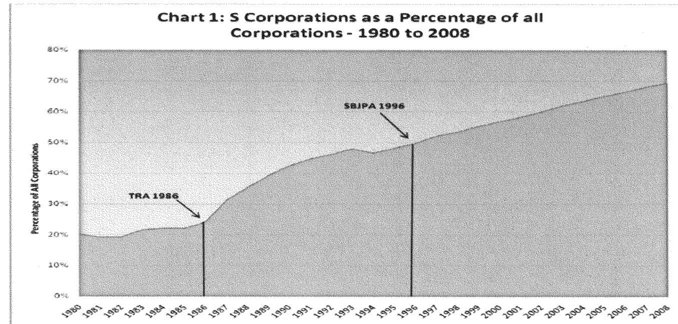
The problem, however, with this approach under the old regime was that those after-tax earnings at the corporate level were supposed to be taxed again at ordinary income tax rates when ultimately distributed to the individual shareholders, resulting in an aggregate cumulative tax burden of 83.8 percent,[4] and this is even before taking state income taxes into account. There were some limited exceptions to this extremely high marginal tax rate system.[5] However, these alternatives generally involved the complete liquidation of either the corporation or the individual taxpayer, which, for obvious reasons, was not always the preferred alternative.

This tax dynamic set up a cat and mouse game between Congress, the Department of the Treasury and the Internal Revenue Service (the "Service") on the one hand and taxpayers and their advisors on the other, whereby C corporation shareholders sought to pull money out of their corporations in transactions that would subject them to the more favorable capital gains rates that were prevalent during this period or to accumulate wealth inside the corporations. Congress reacted by enacting numerous provisions that were intended to force C corporation shareholders to pay the full double tax, efforts that were only partially successful. These provisions included Internal Revenue Code (the "Code") Sections 302 (treating certain redemptions of corporate stock as "dividends") and 304 (treating the purchase of stock in related corporations as "dividends"), as well as Code Sections 531 (imposing a tax on earnings retained inside the corporation other than "for the reasonable needs of the business") and 541 (imposing a tax on the undistributed income of "personal holdings companies" deriving most of their gross income from investments).

Since the taxes at stake could be substantial, the tax opportunities and pitfalls inherent in this system provided tax advisors with a significant source of business. For example, Section 1.537-1(b)(1) of the Treasury Regulations provides that "the corporation must have specific, definite, and feasible plans for the use of such accumulation" in order for such plans to be taken into account for purposes of justifying such accumulation and avoiding the accumulated earnings tax. This led many closely-held business owners to hire attorneys to hold meetings and/or draft corporate minutes when they would otherwise not have incurred the time and expense of documenting such plans so formally.

C. Tax Reform Act of 1986

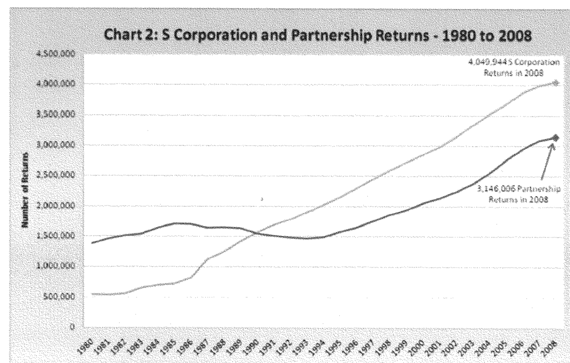
This system started to change with the Economic Recovery Tax Act of 1981 ("ERTA"), which lowered the top individual income tax rate down to 50 percent, i.e., only four percentage points higher than the 46 percent top corporate income tax rate. The prior tax dynamic was even more permanently altered with the TRA '86, which lowered the top individual income tax rate down to 28 percent, the lowest it had been in 57 years. TRA '86 also lowered the top corporate rate, but only to 34 percent. Thus, the relative top tax rate preference for income earned inside and outside of C corporations was actually reversed. That situation did not last long, and today the top income tax rate for both C corporations and individuals is the same, namely 35 percent.



[4] 46% + 70% x (1-46%) = 83.8%.
[5] I.R.C. § 337 (1986).

These TRA '86 changes brought about a dramatic shift in the tax structure for closely-held business owners throughout America. As shown in Chart 1, the number of corporations electing to have corporate income passed through to the shareholders and taxed at the individual level ("S corporations") grew from a little over 20 percent in 1986 to almost 70 percent in 2008 (the last year for which such statistics are currently available). In addition, with the enactment of limited liability company statutes throughout the states during the 1990's and promulgation of the "check-the-box" Treasury Regulations in 1997, business owners were provided with the additional flexibility to have a corporate-like business entity under state law treated as a "partnership" under the Code, which also involved "pass-through" taxation at the individual, rather than at the entity, level.

Thus, closely-held business owners had two alternative "pass-through" taxation structures to choose from: S corporations (the tax rules for which were more restrictive, but much simpler) and partnerships. Chart 2 shows that substantial numbers of closely-held business owners have chosen each of these alternative tax structures, resulting in approximately 4 million S corporations and approximately 3 million partnerships as of the end of calendar year 2008. It should be noted that the partnership category covers a variety of non-corporate business entities, including limited liability companies, general partnerships, limited partnerships, limited liability partnerships and even limited liability limited partnerships, and also includes non-corporate entities formed by publicly held companies. The bottom line is that, although S corporation status appears to be more popular, a very substantial number of pass-through entities have chosen to be taxed as partnerships.



There are a number of policy reasons why S corporations are an excellent vehicle for the conduct of closely-held businesses. First, at current regular rates, the double tax C corporation regime would impose a top marginal federal income tax rate of 57.8 percent,[6] even before the consideration of state income taxes. That is a punishing tax rate for closely-held business owners who correctly perceive their business entities as the extension of their own personal business efforts.

Second, imposing the tax at the individual level has the benefits of complete transparency in terms of who is actually paying the tax, as well as reinforcing whatever progressivity Congress decides to retain in the tax system. As Eric Toder of the Tax Policy Center told the Senate Finance Committee last summer:

> *I would... note that the ideal way to tax business income is the way we tax S corporations. We would like to attribute the income to the owners and the only reason we have a corporate tax is for large and*

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[6] 35% + 35% x (1-35%) = 57.75%.

> *frequently traded companies – very hard to do that and identify the owners who would pay the tax. So where you can do that, we should do that, and that is the right treatment.*[7]

While allocating taxable income among the widely-disbursed ownership of publicly-held companies may be unworkable, that is not the case with closely-held business entities.

Third, the pass-through S corporation regime eliminates the dramatic difference in tax consequences for income earned at the corporate, as opposed to the individual level, thereby obviating the need for more complicated structures and transactions designed to mitigate the heavy burden of the double taxation C corporation system.

This has been borne out in my practice. Prior to the TRA '86, successful business owners were regularly engaged in the tax planning process in order to minimize the substantial burdens under the double taxation regime. Since that time, and with the migration of closely-held business activity to pass-through taxation treatment, business owners are no longer engaged in an ongoing struggle to navigate the heavy impositions of the double tax system. They are less focused on tax planning than they were before the TRA '86, and more focused on running their business. They are keenly aware of the marginal rates that will apply to additional income, and they reserve for that. However, once they have paid that additional tax (often at the top rate), they are comfortable knowing that they can now pull the remaining after-tax earnings out to engage in another business or for their own personal welfare, or retain the money inside the corporation as working capital, to invest in new equipment and other items, or simply as a buffer against future exigencies, without having to worry about any "reasonable compensation" limitations on one hand or "unreasonable accumulations" on the other.

D. Today's Tax Structure

As noted earlier, the tax rate structure in 2012 is still quite consistent with the reforms implemented in the TRA '86. The top individual and corporate income tax rates are identical, at 35 percent. However, now the double taxation burden for C corporation shareholders has been further mitigated by a reduction in the top individual income tax rate for qualified dividends to 15 percent. The net effect of the current rate structure is to impose roughly comparable tax burdens on income earned and retained inside the business for both C corporation and pass-through enterprises. However, the 15 percent double tax on C corporation dividends adds an approximately 10 percent net additional tax burden on earnings distributed, when compared to S corporations. Also, the self-employment tax, which applies to most partnerships and sole proprietorships (but not S corporations), adds an additional tax of nearly 3 percent on enterprises treated as partnerships for tax purposes. These net marginal tax rates for income earned in the top rate brackets are shown in Chart 3.

Chart 3: Top Marginal Tax Rates (2012)

Assumptions: Entity and owners in top tax bracket
Owners active in business and paid reasonable compensation
Not personal service corporation
Partnership income not exempt from self-employment tax
No state income tax

		C Corporation		S Corporation		Partnership / Sole Proprietorship
Additional Income		$ 100,000		$ 100,000		$ 100,000
Less: Entity Income Tax	(35%)	(35,000)		(-0-)		(-0-)
Net Entity Income		$ 65,000		$ 100,000		$ 100,000
Less: Individual Income Tax	(15%)	(9,750)	(35%)	(35,000)	(34.50%)[a]	(34,500)
Less: Self-Employment Tax		(-0-)		(-0-)	(2.858%)[b]	(2,858)
After-Tax Income		$ 55,250		$ 65,000		$ 62,642
Overall Tax Rate:		44.75%		35%		37.36%

[a] 35% x [1 - (1- 1.45%) x 1.45%] = 34.50%
[b] 2.9% x [1 - 1.45%] = 2.858%

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[7] Hearing entitled *How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?* Response to a question before the Senate Committee on Finance, March 30, 2011.

Finally, another factor favoring pass-through tax status for many closely-held businesses is the impact of the C corporation double tax regime upon sale of the business. Most entrepreneurs seeking to sell their business hope to do so at a price in excess of the net book value and tax adjusted basis of its assets. As a consequence, buyers in such sales most commonly seek to achieve "asset sale" treatment for such transactions, whereby they will be entitled to amortize and depreciate the entire purchase price paid, rather than merely deduct the remaining tax adjusted basis inside the seller's entity.[8] However, "asset sale" treatment is particularly onerous in the C corporation context for two reasons. First, there is no capital gains tax preference at the C corporation level. This means that any gain on the sale of the business is first taxed at the top (or close to the top) C corporation tax rate. Second, there is still another tax, albeit at a lower marginal rate, when those proceeds are distributed out to the shareholders upon liquidation.[9]

Nonetheless, as shown in Chart 1, there are still some entities that continue to operate as C corporations. Although no doubt there are a multitude of reasons why specific entities might retain C corporation status instead of converting to some form of pass-through treatment, I have found that there are some recurring situations where corporations might decide to elect or retain C corporation status. The first is publicly held corporations that obviously have more than 100 shareholders, and as a consequence are simply not eligible for S corporation status.[10] Moreover, partnerships engaged in active trades or businesses are generally required to be treated as C corporations if their ownership interests are publicly traded.[11]

Another group of business entities that retain C corporation status would be those that, for one reason or another, are either not eligible for such status and/or would be subject to significant tax at the corporate level, despite S status. Examples of the former would be corporations that have a significant number of ineligible shareholders,[12] or have multiple classes of stock,[13] that are not able to be bought out or otherwise eliminated. An example of the latter would be an entity that, for one reason or another, would be subjected to either an unacceptable amount of built-in gains tax upon conversion[14] or would be subject to the tax on passive investment income and the termination of S corporation status as a result of excess net passive income at the corporate level.[15]

Finally, there are many smaller corporations where the difference between the double tax C corporation regime and pass-through tax treatment is not all that significant. For example, a medical, legal, accounting or other service corporation may regularly pay all or almost all of its profits out in taxable compensation, leaving little or no income to be double taxed inside the corporation and upon distribution, and may also not anticipate selling out at a significant profit at any point in the foreseeable future. Shareholders may buy in and be bought out at relatively modest sums over the years, because there is no anticipation that an acquirer will come in and pay a substantial

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[8] This can be achieved, of course, by an actual asset sale, whereby the buyer purchases all of the assets of the business directly from the business entity. Comparable treatment can usually be achieved even if the acquisition is structured as the purchase of stock or other interests in the entity itself (rather than of its assets). For C corporations, this can usually be accomplished by making an election under Section 338 of the Code. For S corporations, this can usually be accomplished by making an election under Section 338(h)(10) of the Code. For partnerships, this can usually be accomplished by making an election under Section 754 of the Code or by virtue of the deemed liquidation of the partnership upon acquisition.

[9] Code Section 1202 does provide for a 50 percent exclusion (60 percent for certain empowerment zone entities) of gain at the shareholder level in a limited number of circumstances. However, this exclusion does nothing to mitigate the non-preferential tax at the corporate level, and is not applicable to S corporations and other pass-through entities. As a consequence, it is of very little utility to the vast majority of closely held businesses. Thomas J. Nichols, *Choice of Entity Corner – Code Sec. 1202 Stock: Fool's Gold or Worse for Most Taxpayers*, Journal of Passthrough Entities (July-August, 2010).

[10] I.R.C. § 1361(b)(1)(A).

[11] *See* I.R.C. § 7704.

[12] Only citizens, resident aliens, estates and certain trusts and exempt organizations are eligible as shareholders of an S corporation. *See* I.R.C. § 1361(b)(1)(B), (c).

[13] An S corporation may not have more than one class of stock. *See* I.R.C. § 1361(b)(1)(D).

[14] *See* I.R.C. § 1374.

[15] *See* I.R.C. § 1375.

premium in order to purchase the entire business. In such a case, the relatively few tax-free fringe benefits[16] that would otherwise not be available to partners and S corporation shareholders with an ownership interest in excess of 2 percent[17] can be sufficient to justify retaining C corporation status, even though that does require that all compensation paid be subject to full FICA tax.

E. Future Planning

If no Congressional action is taken, the tax landscape will change dramatically as of January 1, 2013. The most significant changes, from a business tax rate perspective, will be the expiration of the tax cuts ushered in with the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the imposition of a new tax on the net investment income[18] of high-income taxpayers under the Patient Protection and Affordable Care Act and the Health Care and Education Act of 2010 (collectively, the "Health Care Acts"). The EGTRRA expiration would cause the top individual marginal income tax rate to increase to 39.6 percent. It would also reimpose the so-called Pease reduction, which reduces itemized deductions at the rate of 3 percent for all income in excess of certain levels of adjusted gross income. The net effect of this latter provision is to increase the top marginal rate to approximately 40.8 percent for most S corporation and other pass-through business income. [19]

The new net investment income tax under the Health Care Acts is imposed on the lesser of net investment income or the excess of modified adjusted gross income over certain thresholds. The thresholds are $250,000 for married couples filing a joint return ($125,000 for married individuals filing separately) and $200,000 for all other returns.[20] This net investment income tax is generally imposed on interest, dividends, annuities, royalties, rents and gains, with one very important exception. Congress recognized that this new imposition should not apply to income derived by owners directly involved in active businesses. Therefore, Congress excluded from the tax base all income derived from a trade or business unless the income was reported by a person who did not "materially participate" under the passive activity rules or the trade or business consisted of trading in financial instruments or commodities.[21] There are still quite a few open issues regarding the application of this tax in various commonplace circumstances, such as the treatment of electing small business trusts, which are special trusts allowed under the Code to be S corporation shareholders. There are also significant unanswered questions regarding the impact of this tax on the sale of stock or interests in an S corporation or other pass-through entity.[22]

As shown in Chart 4, the net effect of these changes would be to drastically increase the top marginal rate on an additional $100,000 of earnings and to create a significantly more complicated system. The marginal rates would increase from a range of 35 percent to 44.8 percent in calendar year 2012 up to a range of 40.8 percent all the way up to nearly 64 percent in 2013. From past experience, I can assure you that any such drastic increase in rates

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[16] For example, benefits under qualified health reimbursement accounts are afforded tax-free treatment for C corporations. *See* I.R.C. § 105. However, health insurance premiums are now entitled to comparable tax treatment for both C corporations and pass-through entities. *See* I.R.C. §162(l).

[17] *See* I.R.C. § 1372.

[18] Although this new tax on net investment income is contained in new Chapter 2A of the Code entitled "Unearned Income Medicare Contribution," my understanding is that the proceeds of this tax will not be allocated to the Medicare Trust Fund, but will instead be included in general government revenues. Therefore, in order to avoid any misconceptions, I do not refer to it as the new Medicare Tax as some commentators do.

[19] This is because state income tax and other deductions usually increase proportionally with income, and so taxpayers never run out of deductions to be reduced.

[20] These thresholds are not inflation-adjusted.

[21] The Health Care Acts also raised the FICA/self-employment tax rate on wages and self-employment income above the $250,000/$125,000/$200,000 thresholds mentioned earlier by .9 percent. Since such wages and self-employment income were already subject to FICA/self-employment tax at the rate of 2.9 percent, the net effect of this change was to increase the gross rate of tax on such wages and income to 3.8 percent, the same as the new tax on net investment income. However, the net effective rate of this new FICA/self-employment tax should usually be somewhat lower than the 3.8 percent tax on net investment income, given the deductibility features of the FICA/self-employment tax system.

[22] *See* Thomas J. Nichols & Joshua L. Cannon, *Impact of the New Health Care Bills on Closely held Business*, New York University 69th Institute on Federal Taxation, Ch. 2 (2011). Updated versions of this article reflecting subsequent developments and analysis are available from Meissner Tierney Fisher & Nichols S.C.

will result in substantial income tax planning regarding the timing of both income and deductions at the end of this year. The only thing preventing the devotion of substantial resources toward this effort now is businesses' confidence that Congress will do something to mitigate this sudden and drastic increase in rates for next year.

From a choice of entity standpoint, this new tax on net investment income will significantly increase the double tax on shareholders of C corporations, because the law seems clear that the trade or business of the C corporation will not be attributed to its shareholders and so no exemption will be available.

Chart 4: Top Marginal Tax Rates (2013)

Assumptions: Entity and owners in top tax bracket
Active owners paid reasonable compensation
Exemptions fully phased out; itemized deductions still reduced
Not personal service corporation
Partnership income not exempt from self-employment tax
Not portfolio, non-TOB income
No state income tax

	C Corporation	S Corporation		Partnership / Sole Proprietorship	
	Dividends	Passive / Trading	Active Non-Trading	Passive / Trading	Active Non-Trading
Additional Income	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Entity Income Tax	(35,000) [a]	(-0-)	(-0-)	(-0-)	(-0-)
Net Entity Income	$ 65,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Individual Income Tax	(26,512) [b]	(40,788) [b]	(40,788) [b]	(40,788) [b]	(40,205) [d]
Individual Net Inv Inc. / SE Tax	(2,470) [c]	(3,800) [c]	(-0-)	(3,800) [c]	(3,745) [e]
After-Tax Income	$ 36,018	$ 55,412	$ 59,212	$ 55,412	$ 56,050
Overall Tax Rate:	63.98%	44.59%	40.79%	44.59%	43.95%

a. 35%
b. 1.03 x 39.6% = 40.788%
c. 3.8%
d. 40.788% x [1 - (1.45% + 1.0145)] = 40.205%
e. 3.8% x (1-1.45%) = 3.745%

This new tax also adds a level of cost and complexity for S corporations and other pass-through entities. For example, if an S corporation has a mix of active and passive shareholders, right now the top tax rates applying to both groups are the same – 35 percent. Starting next year, however, the tax rate on active shareholders would be 40.8 percent, while passive shareholders would face a top rate of almost 45 percent (after taking into account the 3.8 percent tax on net investment income). Not only does this higher rate reflect a higher tax burden on the business, it also has the effect of draining resources from the business. S corporations typically try to distribute enough earnings for their shareholders to pay the tax on the income passed through from the business. With the single class of stock restriction, these distributions must be proportional, which means that, starting in 2013, many S corporations will need to distribute 45 percent of their earnings just to pay the business' taxes, compared to 35 percent today.

Probably the most detrimental aspect of this new tax structure is the fact that it would eliminate the relative parity in top marginal tax rates for both individuals and C corporations. The 45 percent top individual tax rate will once again be substantially higher than the 35 percent (or even lower) top tax rate inside C corporations. If nothing is done, this 10 percentage point or greater difference would reverse the extremely important reform first introduced in TRA '86, and the resulting trend toward the single tax regime that is both more transparent and less subject to manipulation.

F. Tax Proposals

In addition to addressing the issue of tax rates, I understand that there are a number of proposals relating to the tax treatment of closely-held business that are being considered.

1. **Base Broadening**

I understand that there are proposals to broaden the business tax base in order to lower the C corporation income tax rate on a revenue neutral basis. While lowering that 35 percent rate (which puts the United States at the very top of the industrialized countries in terms of marginal rates) is an extremely laudable goal, it is important to recognize that, if this is done in the context of only lowering the C corporation income tax rate, the net effect of this "reform" would be a substantial overall tax increase for the vast majority of closely-held businesses. This is because, as indicated earlier in my testimony, the large majority of closely-held businesses are operating as pass-through entities, which means they would be unaffected by any reduction in the C corporation income tax rates.[23]

An Ernst & Young study conducted on behalf of the S Corporation Association earlier last year made clear the challenge corporate-only tax reform presents to pass-through businesses. According to the study, a broad policy of eliminating business tax expenditures while cutting only corporate rates would raise the tax burden on pass-through businesses by approximately $27 billion per year.[24] This is important because pass-through businesses employ over 54 percent of the private sector workforce, and, as my earlier testimony indicates, anything that affects the cash flow of closely-held businesses (and taxes certainly do) will unavoidably have a depressant effect upon their contribution to the economy.

2. **Forced C Corporation Treatment**

There have also been proposals to force double tax C corporation treatment on large pass-through entities, say those having gross receipts over $50 million. In addition to imposing a substantial additional compliance and tax burden on the most productive members of the pass-through sector of our economy, such a provision would require a detailed and complicated system of inter-related rules. For example, how would an entity be treated that hovers both above and below the $50 million trigger point? Would the built-in gains tax apply when the entity re-elects S status after having been forced into C corporation status as a result of having extraordinarily good receipts during the testing period? Would an entity be trapped in C corporation status even though it no longer had $50 million of gross receipts, because of higher receipts during the testing period? If not, would closely-held business owners not be in a position to know whether they will be subject to a C corporation or S corporation tax regime until after the end of the year in question?

Also, I am assuming that there would have to be some type of aggregation rules so that closely-held business owners could not simply split their business into two or more entities and avoid the C corporation regime in that fashion. As you can imagine, such aggregation rules are extremely difficult to administer. For example, if various business entities were to constitute a series of overlapping aggregated control groups or affiliated service groups, how would that be handled? If one of the groups was below the threshold and another of the groups was above the threshold, would the owners of the group that was below the threshold be forced into double tax C corporation status, even though some of them owned only an interest in a relatively small business?

Even in the absence of multiple overlapping groups, how would you handle the numerous complexities that are involved when multiple entities are treated as a single unit? The consolidated return regulations span over 440 pages in the standard edition of the CCH Income Tax Regulations, dealing with issues such as inter-company transactions, stock investment accounts, calculation of credits, allocation of income tax liabilities and numerous other matters. These complexities are difficult enough for groups of business entities that voluntarily choose to treat themselves as a single affiliated group, but this level of complexity would be multiplied many times by forcing aggregate treatment for all tax purposes on an amalgamation of corporations, partnerships, limited liability companies and other entities that happen to be linked by common ownership or activities.

This forced amalgamation might also have the unintended consequence of opening up opportunities for aggressive tax planning and tax shelters. For example, if dividends are treated as coming from the aggregate

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[23] Moreover, as pointed out earlier, many closely held C corporations do not retain a substantial amount of income at the corporate level, and even fewer of them retain income subject to the top marginal rates.

[24] Robert Carroll and Gerald Prante, ***The Flow-Through Business Sector and Tax Reform***, Ernst & Young (April 2011). Available at: http://www.s-corp.org/2011/04/13/links-to-s-corp-study-and-press/

earnings and profits of the amalgamated entity, could the C corporation owners of one of the amalgamated entities drain off all of the earnings and profits on a tax-preferred basis, while allowing the remaining individual owners to achieve the equivalent of S corporation treatment as a result of non-dividend distributions? If not, would the individual owners of one of the separate entities with separately treated earnings and profits be able to achieve S corporation-type treatment by carefully managing the operations of that entity?

In addition to these workability concerns, making an arbitrary and involuntary cutoff for pass-through tax treatment is simply not good tax policy. For the reasons indicated at the outset of this testimony, the double tax C corporation system is not preferred tax policy. Moreover, the $50 million trigger (or whatever number is chosen as the trigger) would clearly discourage growth in companies that are approaching that level, and such companies would be incentivized to engage in a great deal of sophisticated and expensive tax planning to avoid being involuntarily subjected to the double tax system. Such maneuvers might nonetheless be justified if such a proposal were enacted, because one additional dollar of gross receipts could literally trigger millions of dollars of federal tax consequences. Such cliff-like triggers are obviously not favored for policy purposes.

Finally, just because an entity has $50 million of gross receipts does not mean that it is profitable. There are many such entities (or amalgamations of such entities) that actually have losses, which, under current law, are appropriately taken into account (and if necessary carried over) at the individual level. Forcing individual owners at that level of activity to forego the ability to deduct these losses would unavoidably impact their willingness to continue to fund these enterprises, with the concomitant impact on the jobs and financial security of their employees. Even profitable entities would not seem to merit such draconian treatment. For example, a low-margin 1 percent-of-sales business could easily have $50 million of gross receipts, but have only $500,000 of actual taxable income. Triggering C corporation status in these circumstances seems entirely unwarranted.

3. <u>Buffett Rule</u>

Another proposal that should be considered in this context is the so-called "Buffett Rule." While the Administration has not fully articulated its Buffett Rule proposal, legislation has been introduced in both the House and the Senate (H.R. 3903 and S. 2059) to impose a version of the Rule. As introduced, this provision would generally impose an effective tax rate of 30 percent on adjusted gross income without taking any itemized deductions (other than charitable contributions) into account for individuals earning over $2 million, including a phase-in for taxpayers making between $1 million and $2 million.

In effect, this legislation would impose a third tax on high income taxpayers – first the individual income tax, next the Alternative Minimum Tax, and then finally the Buffett Rule tax – and would raise numerous fairness and administrative complexity issues. For example, the marginal rates incurred by individuals earning between $1 million and $2 million could, in some circumstances, be as high as 60 percent. The Buffett Rule would also exacerbate the C corporation double tax problem I outlined earlier by imposing a minimum tax rate of approximately 55 percent[25] on distributed C corporation earnings, an increase of approximately 10 percentage points from this year's rate.

As for S corporations, earlier I discussed the challenge of appropriately distributing sufficient earnings for S corporation shareholders to pay taxes on the business' income. The Buffett Rule would exacerbate this challenge by forcing an S corporation to calculate and distribute additional earnings, even if only one of its shareholders has (or might have) income subject to the Buffett Rule. The result would be to drain additional capital and resources from S corporations seeking to build up their equity and working capital.

Finally, perhaps the most dramatic and unfair consequence of the Buffett Rule for closely-held business owners would occur in the context of a sale of the business. The current federal tax rate for sale transactions is 15 percent and is scheduled to increase to 20 percent starting next year (before taking into account the 3.8 percent additional tax on net investment income under the Health Care Acts). The Buffett Rule would increase this tax rate for taxpayers making more than $1 million, even if that higher income was triggered by a "once in a lifetime" transaction involving sale of a business built up over decades.

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[25] 35% + 30% (1-35%) = 54.5%

4. **Forced Single Pass-Through Treatment**

One last tax reform proposal that I understand has been considered is the possibility of forcing all pass-through entities into either S corporation or partnership tax treatment. If I was designing a system from scratch, I would consider doing this. However, as shown in Chart 2 earlier, we now have over 7 million pass-through businesses operating in the country, approximately 4 million of which are taxed under the S corporation regime and the remaining approximately 3 million of which are treated as partnerships. Thus, any forced channeling of all pass-through activity through either one of these vehicles would unavoidably impose substantial additional tax compliance costs and other consequences on a substantial number of ongoing businesses. It is important to balance that unavoidable disruption against the likely benefits of any such forced uniformity.

In this regard, it important to note that the vast majority of costs involved in establishing and maintaining such a two-track system have already been incurred. The Treasury Department has already promulgated comprehensive regulations for both partnerships and S corporations, and the Service has developed detailed tax forms and instructions for both types of entities. Moreover, individual taxpayers have already made their choice of entity, and they will not need to learn another system unless they voluntarily elect to change their tax treatment.[26]

As a consequence, the bulk of the ongoing cost of this two-track system is effectively borne by law and accounting students and tax advisors who have to learn and apply both sets of rules. However, no significant long-term benefit would seem to accrue to the economy as a whole by forcing all pass-through taxpayers into a single regime.

[26] This is assuming that no forced conversion to C status is ever enacted.